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Report No. 1416
May 6, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1416 – Report on Proposed Regulations under Section 250 (Foreign Derived Intangible Income)*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1416 commenting on the Proposed Regulations under Section 250 relating to foreign derived intangible income. A prior Report of ours, submitted on September 4, 2018, made suggestions for the Department of the Treasury and Internal Revenue Service (collectively, "Treasury") to consider in issuing Regulations. This Report comments on the Proposed Regulations and comments requested by Treasury. We commend Treasury on the thoughtful approach of the Proposed Regulations.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

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Report No. 1416

New York State Bar Association Tax Section

Report on Proposed Regulations under Section 250 (Foreign Derived Intangible Income)

May 6, 2019

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I. Introduction

This Report[1] comments on proposed regulations (the "**Proposed Regulations**")[2] issued by the Department of the Treasury and the Internal Revenue Service (together, "**Treasury**") under new Section 250.[3] While our prior report (the "**Prior Report**"),[4] submitted September 4, 2018, made suggestions for Treasury to consider for regulations under Section 250, this Report focuses on the Proposed Regulations and comments requested by Treasury.

Part II of this Report contains a summary of our recommendations. Part III contains a detailed discussion of our recommendations. This Report does not provide a comprehensive overview of the statutory and proposed regulatory framework for Section 250, but rather addresses specific issues with respect to which we have comments and recommendations. Our comments do not address all aspects of Section 250 and the Proposed Regulations.

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-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

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1 The principal drafters of this report are Peter A. Furci and Brian Krause. Significant contributions in the drafting of this report were provided by Samuel M. Duncan, Michael Cardella, David Rock, Molly Bailey Klinghoffer, Cameron E. Rotblat and Lillian Aston. Helpful comments were provided by Kimberly Blanchard, Andy Braiterman, Jonathan Brenner, Peter Connors, Patrick Cox, Meyer Fedida, Kevin Glenn, Michael Levin, Richard Nugent, Deborah Paul, Joshua Ruland, Michael Schler, Eric Sloan, Joseph Toce and Shun Tosaka. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

2 REG-104464-18, 84 Fed. Reg. 8188 (Mar. 6, 2019).

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

4 New York State Bar Association Tax Section Report No. 1399, *Report on Foreign Derived Intangible Income* (Sept. 4, 2018).

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), global intangible low-taxed income ("**GILTI**") under Section 951A, 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 to as the "deemed tangible income return." Section 250(b)(2), (3).

taxpayer establishes to the satisfaction of the Secretary that the property is for a foreign use, and (2) 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.[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]

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, customers in non-U.S. markets. The preamble to the Proposed Regulations (the “**Preamble**”) states that the purpose of the FDII regime is to help “neutralize” the incentive that the GILTI regime provides to U.S. corporations to conduct business activities directed at foreign markets through CFCs rather than directly from the United States.[9] In articulating the detailed rules necessary to implement the FDII regime, we believe that it is important to keep this objective in mind, as the advantages of conducting business through a CFC can only be neutralized if the FDII rules are reasonably administrable by taxpayers without undue burden and cost.

The Proposed Regulations provide detailed rules to assist taxpayers in applying the statutory provisions, including rules on defining foreign use for sales and services, rules for the treatment of branches and branch income, rules for treatment of partnerships as domestic or foreign, documentation requirements, and rules for related party transactions.

II. Summary of Principal Recommendations

The following is a summary of the principal recommendations in this Report.

A. Determination of Foreign Branch Income

We recommend the final regulations confirm that the adjustments to foreign branch income in Proposed Regulation section 1.904-4(f)(2)(vi) apply when calculating branch income for the purposes of determining a corporation’s DEI.

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

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

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

[9] 84 Fed. Reg. 8188. *See also* 84 Fed. Reg. 8201-02.

B. Proposed Regulation Section 1.250(b)-3(g): Partnerships as Persons

We believe that Treasury should consider alternative approaches for determining whether a partnership is treated as a domestic or foreign person that are not based solely on the partnership's place of organization. In formulating an approach, Treasury should balance the intent of Section 250, ease of administration and the approach's precision. However, we do not believe Treasury should adopt an approach that treats partnerships as a pure aggregate, due to its administrative complexities.

C. Sales or Licenses of Intangible Property

Treasury should consider whether the rule that applies to tangible property subject to modification outside the United States should be adopted for intangible property. As modified to apply to intangibles, this rule could distinguish between "production" intangibles, such as know-how, patents and other intangibles that inherently contribute to the manufacturing process, and "marketing" intangibles, such as trademarks, that do not contribute directly to the manufacturing process. Production intangibles that are used in the development or manufacture of a product outside the United States could be considered to be for foreign use, irrespective of the location of the end-users of the product. On the other hand, marketing intangibles could be treated as for foreign use only to the extent that end-users of the product are located outside the United States. Whether the rules for tangible and intangible property should be harmonized in this manner, however, depends on a policy decision, namely, whether to advance the policy of neutralizing the incentive that the GILTI regime creates for U.S. companies to operate through CFCs or to advance the policy of motivating companies to manufacture in the United States.

Further, we recommend that the rule for determining foreign use in the case of a sale of intangible property for a lump sum should be harmonized with the rule for sales for periodic payments. Specifically, the seller of intangible property to a foreign person for a lump sum should be required to establish foreign use based upon the amount and location of the revenue that the *buyer* earns or expects to earn from exploiting the intangible property, unless the seller is unable to obtain the necessary information.

D. Sales of Tangible Property

We recommend that final regulations provide that sales of tangible property to foreign retailers that sell primarily through physical locations outside of the United States are presumed to be for a foreign use absent actual knowledge on the part of the U.S. seller to the contrary.

For purposes of determining whether a product is properly considered a "component" of a second product, final regulations should provide that (i) a product is considered a component of a second product if the value of the first product is less than

50% of the value of the finished product and (ii) formally separate components each of which is added to a subsequent product should not be aggregated for these purposes, unless the U.S. seller has actual knowledge that separate components will in fact be combined or the inherent nature of the components compels them to be sold together.

E. Foreign-Derived Income from Services

We recommend revising the documentation rules to provide greater flexibility to taxpayers to comply using any reasonable method, or to provide simple forms that do not require the recipient to provide confidential, proprietary or unduly burdensome information that can be used to satisfy the requirements.

F. Related Party Sales and Amended Returns

For sales to related parties where the unrelated party sale occurs in a subsequent tax year, we recommend Treasury consider alternatives to requiring a taxpayer to amend its tax return for the year of the related party sale. Possible approaches include a "credit approach" under which the taxpayer would receive credit for the year of the subsequent sale equal to the tax benefit it would have received had the FDII deduction in the year of the related party sale been permitted. Alternatively, another approach would be to provide taxpayers with an election to reflect the FDII deduction attributable to the related party sale in the later tax year.

G. Coordination with Section 163(j)

We recommend that the FDII deduction not be taken into account in determining a partnership's ATI.

H. Applicability Dates

We recommend revising the applicability date so that the proposed documentation rules will apply as of the second anniversary of the date the regulations are finalized. We further recommend allowing the transitional documentation rules to continue to apply to sales or other transactions pursuant to contracts entered into on or prior to March 4, 2019 and that have not been subject to a material modification after March 4, 2019, for an additional period of two to three years beyond the applicability date of the final regulations (depending perhaps on when the applicability date of the final regulations is).

III. Detailed Discussion of Recommendations

A. Determination of Foreign Branch Income

The first step in determining FDII of a domestic corporation is to determine the corporation's DEI.[10] One of the specific exclusions from DEI is foreign branch income, which consists of business profits attributable to one or more qualified business units ("**QBUs**").[11] In our Prior Report we urged Treasury to clarify the applicable method for determining the amount of business profits attributable to a QBU.[12]

The Proposed Regulations define foreign branch income by cross-reference to Proposed Regulation section 1.904-4(f)(2).[13] Proposed Regulation section 1.904-4(f)(2) provides that gross income is attributable to a foreign branch to the extent the gross income is reflected on the separate set of books and records of the foreign branch.[14] As noted in both our Prior Report and our Report on the Proposed Foreign Tax Credit Regulations, we believe this is a suitable approach for determining branch income as it generally yields a fair representation of the financial results of a foreign branch.[15]

1. Definition of Foreign Branch Income

The Proposed Regulations depart from the definition of foreign branch income in Proposed Regulation section 1.904-4(f)(2) by including in the concept of foreign branch income any gain from the direct or indirect sale of any asset that produces gross income attributable to a foreign branch, including by reason of sale of a disregarded entity or interest in a partnership.[16] Thus, income from the sale of an interest in a disregarded

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10 Section 250(b)(3)(A).

11 *See* Sections 250(b)(3)(A)(i)(VI), 904(d)(2)(J)(i), 989(a).

12 Prior Report at 6.

13 Prop. Treas. Reg. § 1.250(b)-1(c)(11).

14 Our Prior Report had urged Treasury to adopt rules similar to those found in Section 987 and Treasury Regulation section 1.987-2(b). *See* Prior Report at 6. The approach adopted by Proposed Regulation section 1.904-4(f)(2) is generally analogous to these rules. *See* New York State Bar Association Tax Section Report No. 1408, *Report on the Proposed Foreign Tax Credit Regulations* (Feb. 5, 2019) (the "**FTC Report**"), at 31.

15 *See* Prior Report at 7; FTC Report at 31.

16 Prop. Treas. Reg. § 1.250(b)-1(c)(11). In contrast, under Proposed Regulations section 1.904-4(f)(2)(iv), gross income attributable to a foreign branch does not include gain from the sale of an interest in a partnership or other pass-through entity or an interest in a disregarded entity unless the gain from the sale of the interest is reflected on the books and records of the foreign branch and the interest is held by the foreign branch in the ordinary course of its active trade or business. An interest

entity or partnership owned by a foreign branch would be treated as foreign branch income and excluded from gross DEI. The expanded definition of foreign branch income for purposes of computing FDII would also appear to treat any income inclusion to a foreign branch under the Section 367(d) analogue as foreign branch income, resulting in such income being excluded from gross DEI and thereby reducing a taxpayer's FDII deduction.

We generally believe the Proposed Regulations correctly expand the definition of foreign branch income in order to provide an accurate reflection of DEI. Treating gain from the direct or indirect sale of any asset that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or interest in a partnership, as other than foreign branch income would appear to have the effect of artificially inflating the FDII deduction because such gain would not generally relate to domestic intangibles. However, in the interest of understanding the policy decision, we believe that the preamble to the final regulations should explain the reason for this departure from the definition of foreign branch income used for purposes of Section 904.

2. Treatment of Otherwise Disregarded Transactions

As stated in our Prior Report, an important issue in determining the amount of profits attributable to a foreign branch is how to treat transactions that are generally disregarded for U.S. tax purposes.[17] We interpret the Proposed Regulations to provide for the recognition of certain transactions that are otherwise disregarded, by defining foreign branch income by cross reference to Proposed Regulation section 1.904-4(f)(2).[18] Under Proposed Regulation section 1.904-4(f)(2)(vi), foreign branch income would be adjusted to reflect certain transactions between a foreign branch and its foreign owner, as well as transactions between or among foreign branches that involve payments that would be deductible or capitalized if the payments were regarded for U.S. tax purposes. Payments made by a foreign branch to its foreign owner may result in a downward adjustment to the gross income attributable to the foreign branch and an upward adjustment to the general category gross income of the foreign branch owner.[19] Adjustments may also apply to payments made by a foreign branch owner to a foreign branch.[20] These adjustments do not change the total amount, character or source of the

is held in the ordinary course of the foreign branch's active trade or business if the foreign branch engages in the same or a related trade or business as the partnership or other pass-through entity (that it holds at least 10% of) or disregarded entity. Prop. Treas. Reg. § 1.904-4(f)(2)(iv).

17 Prior Report at 7.

18 *See* Prop. Treas. Reg. § 1.904-4(f)(2)(vi).

19 Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(B)(1)(ii).

20 Prop. Treas. Reg. § 1.904-4(f)(2)(vi).

United States person's gross income.[21] Foreign branch income is not adjusted for payments of interest and interest equivalents, remittances from foreign branches or contributions to foreign branches.[22]

As noted in our FTC Report, we believe Proposed Regulation section 1.904-4(f)(2) correctly acknowledges that disregarded transactions generally must be taken into account to provide an accurate measure of foreign branch income.[23] We also raised the question as to whether interest and interest equivalent payments between a foreign branch and its foreign branch owner should be taken into account in calculating foreign branch income, as excluding such payments from redetermination invites incongruity between the measurement of taxable income for U.S. purposes and for purposes of the foreign jurisdiction's tax rules.[24]

Although the Proposed Regulations define foreign branch income by cross-reference to Proposed Regulation section 1.904-4(f)(2), the Proposed Regulations do not directly address the application of these adjustments.[25] We recommend the final regulations confirm that the adjustments to foreign branch income in Proposed Regulation section 1.904-4(f)(2)(vi) apply when calculating branch income for the purposes of determining a corporation's DEI.

B. Proposed Regulation Section 1.250(b)-3(g): Partnerships as Persons

1. Treatment of Partnerships

The Proposed Regulations treat a partnership as a person for purposes of determining whether income from the sale of property or the provision of a service is foreign-derived deduction eligible income ("**FDDEI**").[26] The Preamble requests comments on whether there are circumstances where it would be appropriate to treat a partnership as an aggregate of its partners for purposes of determining whether a sale of

[21] Prop. Treas. Reg. § 1.904-4(f)(2)(vi).

[22] Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(C).

[23] *See* FTC Report at 36.

[24] *See* FTC Report at 34-35.

[25] The preamble to the proposed foreign tax credit regulations explicitly references Section 250(b)(3)(A) in explaining the need for Proposed Regulations section 1.904–4(f)(2)(vi). *See* 83 Fed. Reg. 63210.

[26] Prop. Treas. Reg. § 1.250(b)-3(g).

property or a provision of a service to a partnership is a sale or service to a foreign person.[27]

We believe this issue is most acute in the context of the sale of property because the statute requires a sale of property to a person who is not a "United States person" (and for foreign use) in order for income from the sale to qualify as FDDEI.[28] By contrast, services must be provided to a person, or with respect to property, not located within the United States.[29] Accordingly, we considered several approaches as to how to characterize a partnership that is the purchaser of goods for FDII purposes, each of which is briefly described below before being discussed in greater detail.

2. Alternative Approaches to Domestic Partnership Recipients

(a) Pure Entity Approach

The Proposed Regulations adopt a pure entity approach (the "**Pure Entity Approach**"). Under this approach, the sale of property to a foreign partnership for foreign use may constitute an FDDEI sale because the sale is to a foreign person; conversely, a sale of property to a domestic partnership, even if for foreign use, will not constitute an FDDEI sale because the partnership is a domestic person, regardless of the ownership of the partnership or the business it conducts.[30]

(b) Entity Exception Approach

The Pure Entity Approach could be modified to be applied with an exception (the "**Entity Exception Approach**"). Under this approach, a domestic partnership would be presumed to be a domestic person and a foreign partnership would be presumed to be a foreign person; however, these presumptions could be rebutted based on the trade or business activity of the partnership.[31] For example, a domestic partnership could be viewed as a foreign partnership if it is predominantly engaged in a trade or business outside the United States, and a foreign partnership could be viewed as domestic if predominantly engaged in a U.S. trade or business.

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27 84 Fed. Reg. 8192.

28 Section 250(b)(4)(A)(i)

29 Section 250(b)(4)(B).

30 *See* Prop. Treas. Reg. § 1.250(b)-3(g)(i), (ii).

31 *See, e.g.*, Section 861(a)(1)(B).

This approach could also be broadened to look at the trade or business activities of a partnership (wherever organized) and to treat each of the trade or business activities of the partnership as separate "persons" for FDII purposes. Under this approach, so long as the property sold to the partnership was attributable to the partnership's non-U.S. trade or business, such sales would be eligible for the FDII deduction.

(c) Pure Aggregate Approach

Under a pure aggregate approach (the "**Pure Aggregate Approach**") a partnership (domestic or foreign) would be treated as a foreign person to the extent of its direct or indirect foreign partners. The determination of a foreign partner's share of the acquisition of property would be based on the direct or indirect partner's interest in the capital or profits of the partnership.

3. Discussion of Approaches

The Pure Entity Approach can lead to incongruous results because a partnership's place of organization may be chosen for non-tax reasons. For example, a sale of property that would otherwise produce income eligible for the FDII deduction (*e.g.* the documentation and foreign use requirements are met) can be disqualified solely on the basis that the acquirer of the property is a domestic partnership even if all of its partners are foreign (and chose to organize the partnership in a domestic jurisdiction to take advantage of established case law in that jurisdiction, or for non-U.S. tax reasons) or if the partnership's relevant business activities are conducted through a foreign entity that elected to be a disregarded entity rather than a corporation. The advantages of the Pure Entity Approach are certainty, and ease of administration—it leads to a definite result, and requires the least amount of analysis to determine that result.[32] However, we do not think that the underlying policy of the FDII rules requires that a domestic partnership necessarily be treated as a domestic person in all circumstances.

The legislative history provides that a domestic corporation's FDII "is the portion of its intangible income, determined on a formulaic basis, that is derived from serving foreign markets."[33] Further, the Senate Budget Committee Explanation in describing the purpose of Section 250(a) provides that "preferential rates for intangible income derived from serving foreign markets, whether through U.S-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions."[34]

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[32] If Treasury believes that partnerships and corporations should be treated in a consistent manner, the Pure Entity Approach would be conducive to that goal as well.

[33] H.R. Rep. No. 115-466, 622 (2017) (Conf. Rep.) (the "**Conference Report**").

[34] S. Rpt. 115-20, 370 (2017).

Partnerships are common forms of business enterprise and the jurisdiction of a partnership's organization is not indicative of whether the partnership is otherwise "serving foreign markets." In addition, a domestic partnership may conduct business through a foreign disregarded entity. As a result, business investment decisions may be distorted by arbitrarily favoring the sale of property to partnerships organized outside of the United States.

The Code utilizes a pure entity approach in certain contexts. For example, Section 957(c) applies a pure entity approach with respect to domestic partnerships for purposes of determining whether a person is a United States shareholder of a controlled foreign corporation ("**CFC**").[35] This approach similarly disfavors the use of a domestic partnership when making investments in a foreign corporation because the partnership may be treated as a 10% United States shareholder, aggregating the interests of small U.S. owners and non-U.S. owners of the partnership for purposes of CFC treatment. This can lead to small United States shareholders being required to take into account their distributive shares of subpart F income (determined at the partnership level), simply because they chose to use a domestic rather than a foreign partnership to hold their investment. A pure entity approach places great importance on the choice of entity (which is often driven by non-tax considerations).

The recently proposed regulations under Section 951A recognized that the pure entity approach was problematic in the CFC context because the GILTI rules require significant calculations to be made at the CFC shareholder level. Although the proposed regulations did not adopt a pure aggregate approach (out of fear that it might be "interpreted by taxpayers to exempt small partners of a domestic partnership from the GILTI regime entirely")[36], it did adopt a hybrid approach. Under the proposed Section 951A regulations, a domestic partnership is an aggregate with respect to a United States shareholder that would otherwise own 10% or more of a CFC and an entity with respect to a United States shareholder that otherwise would own less than 10%.[37] The hybrid approach does not change a United States person's preference to invest in a CFC through a non-U.S. partnership. The breadth of the GILTI rules has only increased the incentive to avoid the use of a domestic partnership.

We do not believe Treasury is bound by the usual definition of "domestic" partnership contained in Section 7701(a)(4) and "United States person" contained in Section 7701(a)(30) because Section 7701(a)(4) provides the Secretary with the authority

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[35] *See* Section 7701(a)(30).

[36] 83 Fed. Reg. 51079.

[37] *See* Prop. Treas. Reg. § 1.951A-5.

to provide in regulations situations in which a partnership is not treated as domestic (despite its place of organization).

One alternative is the Entity Exception Approach. Although the Entity Exception Approach does not treat a partnership as an aggregate, it would mitigate in some respects the arbitrary nature of the Pure Entity Approach. The Entity Exception Approach is analogous to the interest source exception contained in Section 861(a)(1)(B). Under the general sourcing rule, a partnership (wherever organized) is considered a resident of the United States if it is engaged in a trade or business in the United States at any time during its taxable year.[38] Under the exception noted above, interest paid by a foreign partnership that conducts business both within and outside of the United States is foreign-source income if the foreign partnership is predominantly engaged in the active conduct of a trade or business outside the United States, the interest is not paid by a trade or business engaged in by the partnership in the United States and the interest paid is not allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

There are two potential ways to apply an analogue to the interest sourcing rules in the FDII context. Under the first formulation, a domestic partnership would be treated as a domestic person unless it is not engaged in a U.S. trade or business at any time during its taxable year and, similarly, a foreign partnership would be treated as a foreign person unless the taxpayer knows, or has reason to know, it is engaged in a U.S. trade or business at any time during its taxable year.

Under the second formulation, a domestic partnership would be treated as foreign if it is predominantly engaged in a trade or business outside of the United States and, similarly, a foreign partnership would be treated as a domestic partnership if it is predominantly engaged in a trade or business in the United States.[39]

Compared to an aggregate approach, this approach has the advantage of not needing to look through tiers of flow-through partners to determine ultimate beneficial ownership, which may be impracticable or burdensome and instead permits a determination to be made at the partnership level. Rules would need to be articulated to determine what "predominantly engaged" means (the term is not addressed by statute or regulation in the context of Section 861), both with respect to the partnership's operations and the type of information a taxpayer would need to rely on.

[38] Treas. Reg. § 1.861-2(a)(2).

[39] The foreign use rule would effectively cover the concern in the sourcing context relating to the location of the underlying business.

Under a broader formulation of the Entity Exception Approach, a partnership (wherever organized) that is engaged in a trade or business outside the United States, even if that was not its predominant activity, would be viewed as a foreign person to the extent of those activities so long as the property sold to the partnership were attributable to those activities. Therefore, the inquiry on FDII eligibility would shift away from the jurisdiction of organization of the partnership (or the domicile of its partners) and towards whether the goods sold were used by the non-U.S. trade or business of the partnership.

While the Entity Exception Approach would avoid some of the arbitrary outcomes discussed above, there are countervailing considerations. A rule that characterizes a partnership as domestic or foreign based on the location of its business activities is consistent with the approach taken for services; however, there are key differences in the statutory language for services (which speak about a person not located within the United States) compared to sales of property (which speak about a person other than a United States person).[40] Given the difference in statutory language, it may be argued that a compelling policy reason would be needed for Treasury to treat a domestic partnership as other than a United States person for these purposes. In addition, adopting such a rule would raise difficult issues around consistency with treatment of corporations (where choice of jurisdiction can produce the same arbitrary results) and treatment of foreign branches of United States persons. Although treating a foreign branch as a foreign person is not inconsistent with the broader goals of the FDII regime, such an approach may be difficult to reconcile with the statutory language.

In contrast to the approaches above, the Pure Aggregate Approach would look at the direct or indirect (in the case of a flow-through partner) partners in the partnership (domestic or foreign) to determine a foreign partner's share of the acquisition of property based on the partner's relative interest in the capital or profits of the partnerships. The amount of FDDEI would similarly be based on this relative percentage ownership by foreign partners for purposes of determining a domestic corporation's FDII.

A Pure Aggregate Approach may be difficult to apply because the seller or provider would need to rely on information provided to it by the acquirer of goods relating to its direct or indirect owners. Foreign acquirers may be reluctant to provide such information (if it is even available). The difficulty associated with obtaining the information necessary to apply aggregate principles to an acquirer that is a foreign partnership may actually frustrate the stated purpose of the FDII deduction.

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[40] Section 250(b)(4). The Proposed Regulations on services, by "locating" a business recipient of services by virtue of where it is engaged in business, appear to follow this approach. *See* Prop. Treas. Reg. § 1.250(b)-5(e)(2) (a service is provided to a business recipient located outside the United States to the extent allocable to the recipient's operations outside the United States).

4. Recommendation

We believe that Treasury should consider alternative approaches for determining whether a partnership is treated as a domestic or foreign person that are not based solely on the partnership's place of organization. In formulating an approach, Treasury should balance the intent of Section 250, ease of administration and the approach's precision. However, we do not believe Treasury should adopt an approach that treats partnerships as a pure aggregate, due to its administrative complexities.

C. Sales or Licenses of Intangible Property

The Proposed Regulations confirm that sales (which, for these purposes, include licenses) of intangible property to a foreign person for foreign use are eligible for the FDII deduction and define intangible property by cross reference to Section 367(d)(4), which includes intellectual property, goodwill and other intangibles.[41]

The Proposed Regulations provide that a sale of intangible property is for foreign use only to the extent that the intangible property generates revenue from exploitation outside the United States, the documentation requirements are satisfied and the seller does not know or have reason to know that the portion of the sale of the intangible property, for which the seller establishes foreign use, is not for a foreign use.[42] Intangible property used by a recipient in the development, manufacture, sale or distribution of a product is considered to be exploited at the location of the end-user when the product is sold to the end-user.[43] If a domestic corporation sells to a foreign person the rights to exploit intangible property both within and outside the United States, a seller may establish foreign use for a portion of the income from the sale based upon the ratio of the revenue generated by the recipient from exploitation of the intangible property outside the United States to the total revenue generated by the recipient from exploitation of the intangible property. The Proposed Regulations also differentiate between sales of intangible property for periodic payments or lump sums.

For periodic payments, the seller must determine foreign use annually based upon the actual revenue earned by the recipient.[44] The seller must also obtain specific documentation indicating the revenue earned by the recipient within and outside the United States.[45] If the periodic payments are contingent on the revenue or profit of the

[41] Prop. Treas. Reg. §§ 1.250(b)-4(b), 1.250(b)-3(b)(4).

[42] Prop. Treas. Reg. § 1.250(b)-4(e)(1).

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

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

[45] Prop. Treas. Reg. § 1.250(b)-4(e)(3)(i).

recipient and the recipient uses the intangible property to develop, manufacture, sell or distribute a product, the seller must obtain documentation indicating the amount of annual revenue earned by the recipient within and outside the United States from sales of the product.[46] Thus, a domestic corporation licensing intangible property for payments contingent on a foreign licensee's revenue or profit may be required to obtain documentation indicating (i) the purposes for which the property is being licensed, (ii) any products that the licensee may develop, manufacture, sell, or distribute using the intangible property, (iii) the annual revenue earned by the licensee from sales of such products within the United States and (iv) the annual revenue earned by the licensee from sales of such products outside the United States.

For lump sum payments, a seller must establish the foreign use of the intangible property from documentation containing reasonable projections of the ratio of the total net present value of revenue the seller would have reasonably expected to earn from the exploitation of the intangible property outside the United States to the total net present value of revenue the seller would have reasonably expected to earn from the exploitation of the intangible property.[47] For sales of intangible property in exchange for periodic payments that are not contingent on the revenue or profit of the recipient, the seller may rely on similar projections if the seller is unable to obtain without undue burden documentation indicating the revenue earned by the recipient from within and outside the United States.[48]

1. Recommendations Regarding Foreign Use of Intangible Property

While the Proposed Regulations provide that general property is for foreign use if it is subject to manufacture, assembly or other processing outside of the United States before any domestic use, no analogous rule is provided for intangible property.[49] Instead, intangible property used in the development, manufacture, sale or distribution of a product outside the United States is only considered to be for foreign use to the extent that end-users of the product are located outside the United States when the product is sold.[50] The Preamble's justification for the disparate treatment between general property and intangible property is that intangible property is not "subject to" manufacture,

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46 *See* Prop. Treas. Reg. § 1.250(b)-4(e)(3)(i)(A), (C).

47 Prop. Treas. Reg. § 1.250(b)-4(e)(3)(i), (iii).

48 Prop. Treas. Reg. § 1.250(b)-4(e)(3)(i)(D).

49 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i)(B). The rule for general property requires that there must be a physical and material change to the property or the property must be incorporated as a component into a second product. *See* Prop. Treas. Reg. § 1.250(b)–4(d)(2)(iii)(A).

50 Prop. Treas. Reg. § 1.250(b)-4(e)(2).

assembly or processing and, because there is no legislative history on the subject, it declined to articulate an analogous rule in the context of intangible property.[51] The Preamble requests comments on whether a similar rule for intangible property would be appropriate.[52]

We believe that whether the rules for tangible and intangible property should be harmonized depends on a policy decision, namely, whether the FDII regime should advance the goal of "neutralizing" the incentive that the GILTI regime provides to U.S. corporations to conduct their foreign market activities through CFCs rather than directly from the United States, as mentioned in the Preamble, or whether the FDII regime should advance the goal of encouraging manufacturing in the United States. Harmonizing the general and intangible property regulations may help neutralize the incentives created by the GILTI regime by providing a U.S. corporation with the FDII rate in circumstances where a similar license by a CFC would have been GILTI. Indeed, the rule could be limited to royalties received by a U.S. corporation with respect to the license of manufacturing intangibles which would have qualified as royalties derived in the active conduct of a trade or business within the meaning of Treasury Regulation section 1.954-2(d) if received by a CFC, as these royalties would be GILTI rather than Subpart F income. This should theoretically reduce the incentive the GILTI regime would otherwise provide a U.S. corporation to carry on these activities through a CFC.

If Treasury does seek to advance the goal of neutralizing the GILTI incentives by harmonizing the rules for general and intangible property, then we believe Treasury should consider distinguishing between intangible property such as know-how, patents and other intangibles that inherently contribute to the manufacturing process ("**Production Intangibles**") and intangibles such as trademarks that do not contribute directly to the manufacturing process ("**Marketing Intangibles**"). Under this construct, Production Intangibles that are used in the development or manufacture of a product outside the United States would be considered to be for foreign use, irrespective of the location of the end-users of the product. On the other hand, Marketing Intangibles would be for foreign use only to the extent that end-users of the product are located outside the United States. We believe the distinction between Production Intangibles and Marketing Intangibles is meaningful and more accurately reflects the economic reality that Production Intangibles will often be used at the place of production as opposed to the place of sale, while the value of Marketing Intangibles is primarily derived from the place of sale.

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[51] 84 Fed. Reg. 8195; *see* Conference Report at 625 n. 1522 ("If property is sold by a taxpayer to a person who is not a United States person, and after such sale the property is subject to 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 by such person, then the property is for a foreign use.").

[52] 84 Fed. Reg. 8195.

In the context of Production Intangibles, we would support the inclusion of rules similar to those used to determine whether general property is for foreign use as a result of being subject to manufacturing, assembly or other processing. These rules would be necessary to prevent situations in which intangible property is moved offshore for immaterial purposes solely to take advantage of these rules and then subject to domestic use.

If, on the other hand, the overriding policy objective of the FDII regime is to incentivize U.S. companies to expand their manufacturing capabilities in the United States, then Treasury may not want to incorporate a manufacturing exception for Production Intangibles. The Proposed Regulations in their current form might in fact encourage U.S. companies that own Production Intangibles that are used to manufacture component parts of a second product to manufacture and export the component product, rather than license the Production Intangibles to a foreign party to manufacture the component. Exporters of component products can rely on the rules for exporting general property, including the manufacturing exception, while exporters of Production Intangibles must determine whether the property produced with the intangible, even if a relatively minor component in a second product, is ultimately used in the United States. However, it should be noted that the Proposed Regulations may not ultimately have this effect and could instead motivate U.S. companies to operate through CFCs to take advantage of the GILTI regime, as described above.

2. Sales of Intangible Property for a Lump Sum

In the context of lump sum payments for intangible property, we appreciate that Treasury recognizes that it may be difficult for a U.S. seller of intangible property to determine where revenue will be generated at the time the sale occurs. However, we believe that documenting foreign use based on reasonable projections of the amount and location of the revenue that the *seller* would have expected to earn from exploiting the intangible property may inappropriately limit or inflate the portion of the sale deemed to be for foreign use.

As illustrated in Example 1 below, if a U.S. corporation agrees to sell intangible property because it believes an unrelated foreign person is better positioned to exploit the intangible property outside the United States, only a small portion of the sale would be deemed to be for foreign use even if both parties to the sale anticipate the majority of the recipient's revenue from exploitation of the intangible property to be generated outside the United States.

Example 1

In conjunction with a proposed sale of intangible property, DC, a U.S. corporation, reasonably projects that it would expect to earn $90 in revenue in the United States and $10 in revenue outside the United States

> from exploiting its intangible property. FP, a foreign person, reasonably projects that it would expect to earn $50 in revenue in the United States and $200 in revenue outside the United States from exploiting the intangible property owned by DC. DC has no basis in the intangible property. DC sells the intangible property to FP in exchange for a lump sum payment of $200. Under the Proposed Regulations, only $20 of DC's $200 gain on the sale of the intellectual property would qualify as FDII sales income.

In contrast, a U.S. corporation that would otherwise exploit certain intangible property primarily outside the United States could sell the intangible property for a lump sum to a foreign buyer that exploits the intangible property entirely within the United States and still satisfy the foreign use and documentation requirements in the Proposed Regulations. The rule in the Proposed Regulations for lump sum transactions would inflate the portion of the sale deemed to be for foreign use. Consequently, whether a portion of the sale is for foreign use turns on the structure of the consideration received—so that a sale of intangible property, for the same ultimate use, may be treated differently under the FDII rules if the payments received are lump sum or periodic. This creates a distortion which should be avoided, subject to administrability concerns.

We believe that the seller of intangible property to a foreign person for a lump sum should be required to establish foreign use based upon the amount and location of the revenue that the *buyer* earns or expects to earn from exploiting the intangible property. In recognition of the administrative difficulty in obtaining this information, if after reasonable efforts the seller cannot obtain such information from the buyer, the seller should be entitled to rely upon reasonable projections of the amount and location of the revenue that seller would expect to earn from exploiting the intangible property. We believe this recommendation is justified by the practical difficulties a seller may face when attempting to obtain information from the buyer who may not wish to divulge the plan or purpose for which intangible property is purchased entirely for commercial reasons.[53]

[53] Obtaining information from the buyer may be especially difficult where parties have pre-existing contracts regarding intangible property. Such contracts almost certainly will not provide for the information sharing required by the Proposed Regulations, and may not be easily modified. Additionally, sharing business strategy or projections with unrelated parties may possibly have antitrust or other legal implications, further increasing the difficulty in obtaining such information.

D. Sales of Tangible Property

1. Definition of "Foreign Use"

Proposed Regulation section 1.250(b)-3 provides rules for determining whether general property has been sold to a "foreign person" for "foreign use" through a series of definitions.

Generally, a "foreign person" is defined by exclusion as any person that is not a "United States person."[54] A United States person, in turn, is defined by reference to the standard definition under Section 7701 of the Code, modified to exclude bona fide residents of certain U.S. territories.[55]

General property is broadly defined as any property other than (i) intangible property (as defined in Section 367(d)(4)), (ii) securities (as defined in Section 475(c)(2)) or (iii) commodities (as defined in section 475(e)(2)(B) through (D)).[56] The latter two categories were excluded from the definition of general property because, in the drafters' views, "such financial instruments are not subject to any use, consumption or disposition outside the United States" so the inclusion of gain from their sale in the definition of FDDEI was inappropriate.[57]

Under the Proposed Regulations, the sale of general property will be considered for a "foreign use" if the seller establishes that either (i) the property is not subject to "domestic use" within three years of the date it is delivered to the customer or (ii) the property is subject to "manufacture, assembly, or other processing" outside of the United States before it is subject to "domestic use."[58] Property is considered subject to domestic use if it (a) is subject to any use, consumption or disposition within the United States or (b) is subject to manufacturing, assembly, or other processing within the United States.[59] Property is subject to "manufacture, assembly, or other processing" if it is "physically and materially changed" or incorporated as a "component" in a second product.[60]

54 Prop. Treas. Reg. § 1.250(b)-3(b)(2).

55 Prop. Treas. Reg. § 1.250(b)-3(b)(10). A "United States person" under Section 7701(a)(30) generally includes citizens and residents of the United States, domestic partnerships and corporations and certain trusts and estates.

56 Prop. Treas. Reg. § 1.250(b)-3(b)(3).

57 84 Fed. Reg. 8194.

58 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i).

59 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(ii).

60 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii).

Whether property has been physically and materially changed is generally determined based on the relevant facts and circumstances, but the Proposed Regulations provide that "minor assembly, packaging, or labeling" does not qualify.[61] If the property is incorporated into a second product, it is considered a "component" only if the fair market value of the property, determined at the time of delivery to the customer, represents no more than 20% of the fair market value of the completed second product.[62]

2. Documentation Requirements

To satisfy the requirement that general property be sold to a foreign person and for foreign use, a taxpayer is required to obtain one or more specific types of documentation under the Proposed Regulations.[63]

There are several fairly straightforward items of documentation which taxpayers may rely on to establish a recipient's status as a foreign person, including (i) a written statement from the recipient attesting that it is a foreign person, (ii) for any entity, documentation establishing that the recipient is organized under the laws of a foreign jurisdiction, (iii) for recipient individuals, valid government-issued identification, or (iv) documents provided to a government or agency thereof detailing the foreign jurisdiction of organization of the recipient.[64]

Similarly, to establish that a sale is for a foreign use, taxpayers are required to provide one or more of several potential types of documentation. Potential forms of documentation include (i) a written statement from the recipient stating that the property is for a foreign use, (ii) a binding contract between the taxpayer and recipient that provides that the recipient's use or intended use is foreign, (iii) documentation of shipment of the general property to a location outside the United States, or (iv) any other forms of documentation prescribed by the Secretary.[65] If general property is fungible in nature and sold in mass, then a U.S. seller can establish that a portion of the mass is for foreign use through market research, including statistical sampling, economic modeling and other similar methods.[66]

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

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

[63] Prop. Treas. Reg. §1.250(b)-4.

[64] Prop. Treas. Reg. §1.250(b)-4(c)(2).

[65] Prop. Treas. Reg. §1.250(b)-4(d)(3).

[66] Prop. Treas. Reg. § 1.250(b)-4(d)(3)(iii).

Documents are only considered reliable, and therefore may be used to demonstrate foreign use, if (a) the U.S. seller does not know or have reason to know that the documentation is incorrect or unreliable, (b) the documentation is obtained by the FDII filing date, and (c) the documentation is obtained no earlier than one year before the date of the sale.[67] A seller has reason to know that documentation is unreliable or incorrect if a "reasonably prudent person" in the position of seller would "question" the accuracy or reliability of the documentation.[68] The "FDII filing date" is, with respect to the sale of property or services, the date, including extensions, by which the seller is required to file an income tax return (or a partnership tax return) for the taxable year in which the gross income from the sale or provision of service is included in gross income.[69]

The definition of "foreign use" in the Proposed Regulations, combined with the scope of the documentation requirements, is likely to make compliance difficult and expensive.

First, as a general matter, it is typically outside the control of a seller where its property is used or resold after the initial sale. Often the initial buyer will not know with certainty where the property will ultimately be used. Indeed, in many cases distributors or other intermediate purchasers may attempt to circumvent an original manufacturer's intended market for products to take advantage of differential pricing regimes or other arbitrage opportunities through so-called "gray market" sales.

Further, we believe there is meaningful risk that foreign customers will not voluntarily provide U.S. sellers the statements described in the documentation requirements of Proposed Regulation section 1.250(b)-4(d)(3). As a general matter, in our experience, foreign persons are typically wary of providing written tax statements and have no incentive to become involved, even tangentially, in U.S. tax matters. Furthermore, long-term sales contracts entered into well before the publication of the Proposed Regulations might need to be renegotiated to accommodate the new regulations and require the foreign customer to provide evidence of its foreign status and foreign use of the property. Even if a foreign buyer were able to provide a certification with minimal inconvenience, these additional documentation requirements would provide an opportunity for the customer to extract concessions, and as a result U.S. sellers could incur significant costs to obtain these certifications.

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[67] Prop. Treas. Reg. § 1.250(b)-3(d).

[68] Prop. Treas. Reg. § 1.250(b)-3(d)(1).

[69] Prop. Treas. Reg. § 1.250(b)-3(b)(1).

While taxpayers may rely on a shipping address outside of the United States to document foreign use, U.S. sellers may be wary of relying on a shipping address because of the limitation that documents may not be relied upon if a "reasonably prudent person" would "question" their accuracy or reliability. While the use of a shipping address to document foreign use could avoid many of the difficulties associated with renegotiating contracts, nevertheless, this documentation option may be of limited practical use. A taxpayer, in the exercise of its reasonable prudence, may have reason to question whether a mere shipping address reliably establishes that property is to be used exclusively or wholly for a foreign use.

Finally, component manufacturers often do not have information regarding into which specific second products their customers are incorporating the purchased component. It is possible that the customer may not even know at the time of purchase. For example, a U.S. manufacturer of ball bearings that sells a large quantity of ball bearings to a foreign manufacturer with a diverse range of second products would likely be unable to trace which of the foreign customer's various second products contain the U.S. manufacturer's ball bearings (as distinguished from a competitor's or some other similar technology) and where geographically they are sold. The foreign manufacturer may not even be able to track its own inventory with such precision. Requiring a U.S. manufacturer, particularly a manufacturer of high-value components, to determine whether the components it manufactured constitute more than 20% of the fair market value of the second product is likely to be burdensome and result in speculation rather than a reliable analysis.

3. Recommendations

It appears that the definition of "foreign use" and the documentation requirements seek to prevent the "round-tripping" of exported products back into the United States from qualifying for the reduced FDII tax rate. We recommend that Treasury reconsider whether the mere fact that general property sold to certain types of unrelated foreign parties, as described below, is eventually used in the United States should disqualify the initial sale from the FDII regime absent some involvement by the U.S. seller in causing that outcome. The Preamble states that the purpose of the FDII regime is to help "neutralize" the incentive that the GILTI regime provides to U.S. corporations to conduct their foreign market activities through CFCs rather than directly from the United States. An arm's length sale by a CFC to an unrelated third party that is a foreign person would generally be eligible for the reduced GILTI rate (assuming the income is not foreign personal holding company or foreign base company income), regardless of whether the property is ultimately imported to the United States by a third party. In contrast, we acknowledge that related party transactions are more susceptible to manipulation and note that Proposed Regulations section 1.250(b)-6 already provides rules directed at determining whether such sales are for foreign use.

Certain types of foreign purchasers present significantly lower risk of re-selling products into the United States. For example, a foreign brick-and-mortar retail store likely sells all of its products to individuals physically located in the jurisdiction where the store is located. While it is certainly possible that products could be sold to a United States person who happens to be in that location, we believe such sales are incidental and it would be impossible or impractical for a U.S. seller (and in many cases, the foreign retailer) to have meaningful insight into the volume of such sales. Accordingly, as suggested in the Prior Report, we recommend that the final regulations presume that sales of finished goods to unrelated foreign retailers (*i.e.*, businesses that sell to end users, with minimal or no modification of the purchased product) that sell primarily through physical locations outside of the United States, are for "foreign use" absent actual knowledge on the part of the U.S. seller to the contrary.[70]

Foreign retailers with worldwide brick-and-mortar stores and/or meaningful sales through e-commerce portals present much more difficult classification questions. On the other hand, a foreign online retailer may have much better information regarding where its goods are directed (*i.e.*, whether it ships primarily to the United States or abroad). As suggested in our Prior Report, we believe there are several possible alternatives for obtaining information from foreign online retailers regarding their intent, or in some cases, generalized information regarding their sales into and outside of the United States.[71]

With respect to sales of components which undergo further manufacturing or incorporation into other products, we believe that Treasury may have derived the 20% fair market value threshold for property to qualify as a component of a second product from both the foreign base company sales income ("**FBCSI**") rules in Treasury Regulation section 1.954-3(a)(4)(iii) and the domestic international sales company ("**DISC**") rules for determining whether property is "for ultimate use in the United States" under Treasury Regulations section 1.933-3(d)(4). Under the FBCSI rules, a CFC is considered to have sold property that it manufactured, rather than having sold the component parts it purchased that are part of the property, if its "assembly or conversion" of the components are "substantial in nature" and "generally considered to constitute the manufacture, production, or construction of property."[72] Under a safe harbor rule, the CFC is deemed to have manufactured the product if its conversion costs (direct labor and factory burden) represent 20% or more of the total cost of goods sold.[73]

[70] Prior Report at 17.

[71] Prior Report at 18.

[72] Treas. Reg. § 1.954-3(a)(4)(iii).

[73] *Id.*

Under the DISC rules, a purchaser of property is deemed to use such property "ultimately in the United States" if (i) the purchaser is related to the U.S. seller and the purchaser ultimately uses the property or property into which the property is incorporated in the United States, (ii) at the time of sale there is an agreement or understanding that such property or property into which the property is incorporated will be used by the purchaser in the United States, or (iii) a reasonable person would have believed that the property or property into which the property is incorporated will be ultimately used by the purchaser in the United States, unless the fair market value of the component is less than 20% of the fair market value of the property into which it is incorporated.[74]

There are inherent significant differences between the FBCSI and FDII manufacturing analyses. First, as previously noted, the 20% cost of goods sold threshold in the FBCSI rules is a safe harbor and not a bright line test. Unlike under the Proposed Regulations, the United States shareholder and CFC can still prove that the CFC was a manufacturer of a product under a facts and circumstances test even if the 20% threshold is not met. Second, the FBCSI rules address parties that are under common control and, therefore, information regarding the total cost of goods of the finished product is readily available. On the other hand, as previously discussed, U.S. component sellers often have a significant information gap regarding into which products their customers incorporate their components and where and at what cost those second products are sold. Moreover, the Proposed Regulations in effect inverted the FBCSI test, making it more onerous without justification for this difference. Under the FBSCI test, the CFC purchaser of the component is considered a manufacturer if its conversion costs represent more than 20% of its costs of goods sold. Under the FDII version of the test, the burden is on the component manufacturer to prove that the component itself represents less than 20% of the fair market value of the finished product.

In addition, the DISC rules are ill-suited to serve as a model for the FDII regime in light of modern trends in international commerce. The DISC rules were promulgated in Treasury Regulations issued in the late 1970s, prior to the wave of globalization caused by the internet, as well as the increase in highly specialized electronic technology manufacturing. For example, we believe that a computer, printer, car, or elevator should be considered fundamentally separate products from the increasingly sophisticated circuit boards incorporated into them, even if those electronic components account for more than 20% of the value of the final product.

In order to account for the material differences between the FBSCI and DISC rules, on one hand, and the FDII rules, on the other, we recommend that the rules for determining whether general property is a component of a second product for purposes of the FDII regime should be modified in the following ways:

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74 Treas. Reg. § 1.993-3(d)(4)(ii).

(1) General property should be considered a component of a second product if the price charged by the U.S. seller of the component constitutes less than 50% of the fair market value of the finished second product. The 20% threshold in the Proposed Regulations is a very specific number that will be difficult for U.S. component sellers to determine with any precision, particularly with respect to second products that are sold through multiple distribution channels at different prices. We believe that U.S. sellers would be able to more readily and accurately determine whether their components represent less than 50% of the value of a second product. In addition, as a policy matter, we believe that a product should be respected as a "second product" manufactured by the foreign customer for purposes of the FDII regime if less than half of its value is derived from the U.S.-supplied component.[75]

(2) Multiple components sold by the same U.S. seller should not be aggregated and treated as a single component unless (i) the U.S. seller has actual knowledge that the components will be included in the same second product or (ii) the inherent nature of the components would compel them to be included in the same second product. This modification would again address the lack of information that U.S. sellers (and sometimes the customers) have regarding the products in which their components are used.

E. Foreign-Derived Income from Services

Proposed Regulation section 1.250(b)-5 provides guidance on when a service is provided to any person, or with respect to property, located outside the United States.[76] Under the Proposed Regulations, the determination of whether a service is provided outside the United States depends on the type of service provided and, in the case of a general service (described below), the type of recipient of the service.

The Proposed Regulations establish four mutually exclusive categories of services: proximate services,[77] property services,[78] transportation services[79] and general

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75 In this regard, we note that the DISC rules also utilized a 50% threshold test to determine whether property exported from the United States is properly considered U.S. property, based on the value of the property compared to the value of any components that were imported into the United States. *See* Treas. Reg. § 1.993-3(e)(1) ("[N]o more than 50% of the fair market value of export property may be attributable to the fair market value of articles which were imported into the United States.").

76 Section 250(b)(4)(B). As noted above, unlike in the context of the sale of property, where the acquirer must not be a "United States person," the statutory language instead refers to recipients of services located outside the United States.

77 Prop. Treas. Reg. § 1.250(b)-5(b)(3).

78 Prop. Treas. Reg. § 1.250(b)-5(b)(4).

79 Prop. Treas. Reg. § 1.250(b)-5(b)(5).

services.[80] General services are further divided between services provided to business recipients[81] or consumers.[82] These classifications are largely consistent with the OECD Guidelines as discussed in the Prior Report.[83] We will discuss each category below in turn before discussing the documentation requirements articulated by the Proposed Regulations.

1. Service Categories

(a) Proximate Services

Proximate Services are defined as services substantially all of which are performed in the physical presence of the recipient (or in the case of a business recipient, employees).[84] The recipient of the services is located where the services are performed. If proximate services are performed partly within and partly outside the United States, a proportionate amount of the services will be treated as being located outside the United States.[85]

(b) Property Services

Property services are defined as services with respect to tangible property where substantially all of the services are performed at the location of the property and the services result in "physical manipulation" such as assembly, maintenance or repair.[86] Property must be located outside the United States for the entire period of performance.[87] The Preamble requests comments on whether to consider an exception for property that is located in the United States temporarily solely for performance of certain services, such as maintenance or repairs.[88]

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80 Prop. Treas. Reg. § 1.250(b)-5(b)(1), (2).

81 Prop. Treas. Reg. § 1.250(b)-5(e).

82 Prop. Treas. Reg. § 1.250(b)-5(d).

83 *See* Prior Report at 21-22.

84 Prop. Treas. Reg. § 1.250(b)-5(c)(6).

85 Prop. Treas. Reg. § 1.250(b)-5(f).

86 Prop. Treas. Reg. § 1.250(b)-5(c)(5).

87 Prop. Treas. Reg. § 1.250(b)-5(g).

88 84 Fed. Reg. 8197. Such a rule may be appropriate in some cases, for example where the property can only be serviced in the United States. We believe it would be helpful to provide for such a rule to

(c) Transportation Services

Transportation services are defined as services to transport a person or property using any mode of transportation.[89] The location of the service is determined by the origin and destination of the transportation, both of which must be outside the United States in order for the service to be entirely an eligible service.[90] In other words, if the origin is outside the United States and the destination is outside the United States, the service is an eligible service, but if either the origin or the destination is within the United States, then only 50% of the service qualifies.

(d) General Services

The category of general services is a catch-all for services not otherwise addressed by the preceding categories. For general services to consumers (individuals for personal consumption), the consumer is located where the consumer resides when the services are provided.[91] For general services to business recipients, the business recipient is located through its location of operations and the operations of any related party of the recipient that received a benefit from the services. Operations are defined as any location where the recipient maintains an office or fixed place of business.[92] The service is provided to a business recipient located outside the United States to the extent the service provider's gross income from the service is allocated to the recipient's operations outside the United States.[93] The above mentioned allocations are based on which operations received a benefit from the service. If this information is unavailable or there is inadequate documentation, the benefit is deemed to apply to all of the business recipient's operations.[94]

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apply where the property was used outside of the United States before repair and maintenance, and is expected to return to such use promptly after the service is completed.

89 Prop. Treas. Reg. § 1.250(b)-5(c)(7).

90 Prop. Treas. Reg. § 1.250(b)-5(h).

91 Prop. Treas. Reg. § 1.250(b)-5(d)(2).

92 Prop. Treas. Reg. § 1.250(b)-5(e)(2)(i)(B)(ii).

93 Prop. Treas. Reg. § 1.250(b)-5(e)(2)(i).

94 Even this "backup" rule may not always be practical—in the case of a private company, it may simply not be possible to determine where the recipient's operations are located.

2. Documentation Requirements

In recognition of the difference between sales and services transactions, the Preamble clarifies that there would be separate documentation requirements for sales and services. The discussion below is focused on the particular documentation requirements for eligible services income.

To meet the documentation requirement for the location of a consumer, a taxpayer must obtain either a written statement indicating that the consumer resides outside the United States when the service is provided, any valid identification issued by a foreign government or relevant agency or any other forms of documentation prescribed by the Secretary.[95] This is generally in line with the Prior Report's proposal to model future guidance on the OECD Guidelines.

To meet the documentation requirement for the location of a business recipient, the taxpayer must provide one or more of the types of documentation described in Proposed Regulation section 1.250(b)-5 and this documentation must support the service provider's allocation of income.[96] Under the Proposed Regulations, permissible documentation includes a written statement from the business recipient of the services that specifies the locations of the operations of the business recipient that benefit from the service, a binding contract that specifies the locations of the operations of the business recipient that benefit from the service, documentation obtained in the ordinary course of the provision of the service that specifies the locations of the operations of the business recipient that benefit from the service and publicly available information that establishes the locations of the operations of the business recipient.[97]

For many of the acceptable forms of documentation, Treasury places significance on where the benefit of the services is received. The Proposed Regulations define benefit, by cross-reference to Treasury Regulation section 1.482-9(l)(3), as an activity that directly results in a reasonably identifiable economic or commercial value that enhances, or may reasonably be anticipated to enhance, the recipient's commercial position.[98] The Proposed Regulations permit any reasonable method for determining the allocation of benefit obtained from the services. We urge Treasury to provide guidance on what methods should be used to determine the amount of benefit a taxpayer ascribes to a service or a particular location if a multinational is involved, and to develop

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[95] Prop. Treas. Reg. § 1.250(b)-5(d)(3)(i).

[96] The documentation rules also contain certain special rules for small businesses and small transactions. *See* Prop. Treas. Reg. § 1.250(b)-5(d)(3)(ii).

[97] Prop. Treas. Reg. § 1.250(b)-5(e)(3)(i)(A)-(E).

[98] Prop. Treas. Reg. § 1.250(b)-5(c)(1).

presumptions that can be applied if (as may often be the case), the service recipient is unwilling to provide information regarding the benefit of the services on grounds of being confidential or proprietary. For example, taxpayers should be able to consider a variety of objective factors, such as the location of the personnel of the service recipient that they worked with, the locations of the recipient where the work was performed, and the substance of the work performed (such as country analysis, etc.) to make a reasonable allocation of benefit.

It would also be helpful for Treasury to further clarify what types of benefits must be taken into account in the allocation, particularly with respect to services performed for a foreign parent corporation that would be expected to benefit the corporate group as a whole. For example, a U.S. financial advisor may provide advice to a foreign parent corporation that is expected to increase the value of the foreign parent's publicly traded stock. That value increase could benefit any U.S. subsidiaries, as well as other foreign subsidiaries, by making their equity based compensation more effective for employee retention. The allocation of such an indirect correlative effect could be very difficult for a U.S. service provider to determine.

The Preamble provides that Treasury "balanced the rigor and reliability of the proof that transactions are foreign-derived with the cost to taxpayers of obtaining such documentation."[99] Treasury further explains multiple possible documentation rules that were considered and ultimately rejected.[100] For example, one possibility was to require appropriate documentation be provided to Treasury before the FDII eligible transaction occurred. This was ultimately rejected as too time-consuming and likely to interfere with taxpayers' ordinary business activities. However, the resulting documentation rules raise practical concerns where a service provider must gather extensive information about where the benefit of rendered services will be realized even if the services are only performed at a single location. Further, we think it would be appropriate for taxpayers to use any reasonable method, consistent with the Proposed Regulations, regarding allocation of benefit.

Treasury states that its aim in proposing the documentation rules was that the rules not alter economic decisions. However, if compliance is too cumbersome, this is inevitable. Further, service providers may struggle in practice to separate the services they provide into the four categories and ensure the correct documentation is collected for each method. Further, the documentation rule for general services is unduly burdensome, requiring the service recipient to allocate the benefit of each service provided, and provide that information to the service recipient.

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[99] 84 Fed. Reg. 8203.

[100] 84 Fed. Reg. 8202-03. Another proposed option was to allow taxpayers to use their own discretion in determining what kind of documentation was appropriate. *See id*.

We recommend that Treasury conform the documentation rules to other currently-existing rules for documentation, under which any reasonable method can be used, or under which simple forms that do not require the recipient to provide confidential, proprietary or unduly burdensome information can be used to satisfy this requirement.[101] This is especially important for parties with long-term contractual arrangements that would need to be revised to allow the service provider to receive what it needs to satisfy the documentation requirements. Such a rule puts a service provider on the horns of an unpleasant dilemma: to give up on the benefit of FDII (as it cannot receive the necessary documentation), or to seek to modify a longstanding arrangement (which could trigger an economic renegotiation).

3. Related Party Services

The Proposed Regulations also address related party services. Under Section 250(b)(5)(C)(ii), a service provided to a related party located outside the United States will not be treated as an eligible service unless the taxpayer can establish that the service is not substantially similar to a service provided by the related party to a person within the United States. The Proposed Regulations clarify that a related party, in this context, is any member of a "modified affiliated group." A modified affiliated group is defined by cross-reference to Section 1504(a) with modifications.[102] Proposed Regulation section 1.250(b)-6 further clarifies how services provided by a related party recipient may be "substantially similar." The service is substantially similar to services provided within the United States where the service provider's service is used by the related party to provide a service to a person in the United States and either the benefit or price test is met.

The price test is met where the service provider's service is used by the related party to provide a service to a third party located within the United States and 60% or more of the price the third party paid is attributable to the original service provider.[103] However, if the service is considered "substantially similar" solely because of the price test, the Proposed Regulations allow a proportionate amount of the service to qualify as FDDEI.[104]

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[101] Other documentation rules, such as the Chapter 3 and Chapter 4 requirement for Forms W-8 and W-9, have been largely successful even where the documentation is provided by a non-United States person that is not generally subject to, or familiar with the U.S. tax laws.

[102] Prop. Treas. Reg. § 1.250(b)-1(c)(17)(i). The definition substitutes "more than 50%" for "at least 80%" and includes foreign corporations and certain insurance companies. *See* Section 1504(a), (b).

[103] Prop. Treas. Reg. § 1.250(b)-6(d)(2)(ii).

[104] Prop. Treas. Reg. § 1.250(b)-6(d)(1).

The benefit test looks to whether 60% or more of the benefits conferred by the related party's services are located in the United States.[105] The Preamble likens the test to comparing the benefit from services provided to persons in the United States to the services provided generally by the service provider.[106] Put another way, the test examines the benefit to the U.S. recipient as against the total benefit generated by the service.

Unlike the Proposed Regulations' discussion of resales for related party sales, there is no discussion of later provisions of related party services. The related party sales rules provide that if a related party sale occurs and, at some point after the FDII filing date a qualifying third-party resale occurs, the taxpayer may amend its return.[107] It is unclear how to apply these concepts to related party services, where the substantially similar service may be provided in a later year. Indeed, the rules appear to operate differently for services than for sales of goods, as related party services can generally qualify for the FDII deduction unless the substantially similar service test is met. Consistent with that framework, one approach would be to allow related party services to be FDII-eligible in the year provided, so long as the substantially similar services test was not triggered in that year, but to require taxpayers to amend their return to reduce the claimed deduction should the substantially similar services test be triggered in a later year. Alternatively, a variation of the approaches discussed below for related party sales could be considered in lieu of requiring an amended return (e.g., reducing the FDII deduction or increasing the tax in the later year).

F. Related Party Sales and Amended Returns

The FDII rules provide that a sale of property to a foreign related party will not be treated as for a foreign use unless the property is sold to an unrelated party, or used by the related party in connection with a sale of property or provision of services to an unrelated party. In the context of a foreign related party sale transaction, the Proposed Regulations provide that if the unrelated party transaction occurs after the due date for filing the tax return for the taxable year in which the related party sale occurred, but within the time period for filing a claim for credit or refund of an overpayment, a domestic corporation may file an amended return for the taxable year of the related party sale claiming the related party sale as an FDDEI sale for purposes of determining the taxpayer's FDII for that taxable year.[108] The Preamble requests comments on whether alternatives should be

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105 Prop. Treas. Reg. § 1.250(b)-6(d)(2)(i).

106 84 Fed. Reg. 8199.

107 *See* discussion of third-party sales, *infra* at III.F.

108 Prop. Treas. Reg. § 1.250(b)-6(c)(i).

considered in lieu of requiring the filing of an amended return.[109] We believe Treasury should consider alternative approaches because, although amending a corporation's tax returns would produce the most precise result, it may be impracticable or unduly burdensome in some cases.

We considered a number of alternative approaches which are intended to have the effect of reflecting the deduction for FDII for any related party sale (i) in the year of the related party sale, to the extent the unrelated party transaction occurs before the due date for filing the tax return for the taxable year in which the related party sale occurred or (ii) in any other case, in the year of the unrelated party sale. This approach could take the form of (1) a "pure" wait-and-see approach, under which the amount of the FDII deduction is determined in the year of the unrelated party sale, (2) a corrective deduction approach, under which the amount of the FDII deduction is determined in the year of the related party sale, but taken into account in the later year or (3) a credit approach, under which the taxpayer would receive a credit against the tax payable in the later year equal to the tax benefit it would have received had the FDII deduction in the year of the related party sale been permitted. These alternatives are discussed in greater detail below.

1. Wait-and-See Approach

Under a wait-and-see approach, the amount of a domestic corporation's FDII deduction arising out of a related party sale would be determined at the time of the subsequent sale to an unrelated party. The domestic corporation would at that later time determine its FDII deduction for that year and (solely for this purpose) treat the income and other items relevant to the FDII deduction as arising in the year of the subsequent sale.

Example 2

DC is a U.S. corporation. FC is a foreign corporation. DC and FC are related parties – FC is a foreign subsidiary of DC. FP is a foreign unrelated third-party. In Year 1, DC sells a clock to FP and realizes $100 of income. In Year 1 DC has $100 of FDDEI (from the clock sale), $200 of DEI (including the clock sale and $100 of other income) and $100 of DII (assuming $100 of deemed tangible income return), resulting in an FDII deduction of $18.75. ($100/$200 x $100 x 37.5%).

[109] 84 Fed. Reg. 8198.

Example 3

Same facts as Example 2, except DC sells the clock to FC in Year 1. As FC is a related party, the sale does not qualify as an FDII eligible sale, and so DC cannot take the $100 related-party sale into account for purposes of determining its FDII deduction. In Year 1 DC has $0 of FDDEI, $100 of DEI (from other sources) and $0 of DII and no FDII deduction.

In Year 3, FC sells the same clock to FP. As FP is a foreign unrelated third-party, the sale qualifies as an FDII eligible sale. Under the wait and see approach, DC may now take into account the income that would have arisen from the sale to FC in Year 1 for purposes of determining its FDII deduction. In Year 3, however, the company has made acquisitions that increase its QBAI, such that its DII (taking into account the income from the related party sale) is $50. DC has $100 of FDDEI, $200 of DEI and $50 of DII (all taking the sale into account). For Year 3, DC has a total FDII deduction of $9.38. ($100/$200 x $50 x 37.5%).

This approach would be administrable, but potentially unfavorable to taxpayers from a time value perspective since the FDII deduction is taken into account in a later tax year. Further, the deferral of the FDII deduction, or the deferral of the foreign-derived income for purposes of calculating the FDII deduction, may have other, undesired consequences. For example, the taxpayer may not have net positive taxable income (or net positive DEI or FDDEI, or may have higher QBAI) in the later year, preventing it from fully benefiting from the Section 250(a) deduction. However, in certain circumstances, the deferral may benefit the taxpayer. For instance, the taxpayer may have net positive taxable income in the later year but not in the initial year. Similarly, this approach may have either adverse or beneficial consequences where the domestic corporation's tax attributes change in intervening years (for example, the FDII deduction in the later year may displace an intervening NOL).

2. Corrective Deduction Approach

Under a corrective deduction approach, the amount of a domestic corporation's FDII deduction arising out of the related party sale would similarly be determined at the time of the subsequent sale to an unrelated party. However, unlike the wait-and-see approach, the taxpayer would receive a deduction in the later year equal to the amount of the deduction that the taxpayer would have received at the time of the initial related party sale.

Example 4

> Same facts as Example 3. When DC sells the clock to FP, DC applies the corrective deduction approach and takes into account the FDII deduction that would have arisen from the sale to FC in Year 1. The amount of FDII deduction that would have been attributable to the sale of the clock in year 1 is $18.75.[110] Thus for Year 3, DC has a total FDII deduction of $18.75.

Although this approach would attempt to solve for differences in DEI, DII and FDDEI between the two tax years, there could still be an impact to the domestic corporation from the variation of its tax attributes over the intervening years. Further, the taxpayer again is subject to unfavorable timing differences in that the deduction is allowed in a year following the original sale.

3. Credit Approach

Under a credit approach, the domestic corporation would receive a tax credit for the year of the sale to the unrelated party equal to the tax benefit it would have received had the FDII deduction in the year of the related party sale been permitted.

Example 5

> Same facts as Example 3. Under the credit approach, in Year 3 DC obtains a credit equal to $3.94[111] upon the sale to FP that DC could utilize to reduce its tax liability for Year 3.

Although this approach would reach the same economic result as Example 4, it would not be as susceptible to the variation of DC's tax attributes over the intervening years. It also would avoid separating the income in Year 1 from the deduction in Year 3. However, there would still be unfavorable timing differences for DC, as the use of the credit would occur in a year following the original sale.

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110 To calculate the FDII deduction attributable to the sale of the clock, the taxpayer calculated the FDII deduction as if the sale were included in Year 1 and then determined the difference between Year 1 with the sale and Year 1 without the sale.

111 $18.75 x 21% (assuming the full amount of the FDII deduction is used to reduce DC's taxable income).

4. Recommendation

To facilitate administrability, we believe that Treasury should strongly consider allowing taxpayers to make a one-time election to adopt the credit approach and eliminate the requirement to file an amended return. Of the various approaches, the credit approach appears to come closest to putting the taxpayer in the same position as if the FDII deduction had been allowed in the year of the related party sale. To avoid inappropriate planning, taxpayers should be required to adopt a consistent approach for related party sales for all taxable years that can be changed only with the consent of Treasury. Requiring taxpayers to adopt a consistent approach should reduce the potential for planning abuse. We acknowledge that even with a one-time election taxpayers may still be able to engage in some degree of planning regarding the timing of related party sales. We also acknowledge that the credit approach is not devoid of its own administrative and conceptual complexities. For example, rules may be needed to address scenarios where there are multiple sales to related parties in multiple years and multiple subsequent sales by the related parties to unrelated parties. Further, whether or not the credit approach is adopted, we urge Treasury to provide coordination rules governing the interaction of FDII, GILTI and the taxable income limitation in Section 250(b) due to the knock-on effects that may arise as a result of the application of the related party sale rules.

It is worth noting that the statute does not contemplate reflecting the FDII deduction in a year other than the year of the related party sale. As a result, Treasury may conclude that the credit approach is easier to defend on authority grounds than the other approaches.

G. Coordination with Section 163(j)

The Proposed Regulations request comments on how the FDII deduction should be accounted for in determining adjusted taxable income ("**ATI**") at the partnership level under Section 163(j)(4)(A).[112]

We recommend that the FDII deduction not be taken into account in determining a partnership's ATI, because the FDII deduction is a partner-level deduction and may only be taken into account by domestic corporate partners. We believe this approach is analogous to approaches taken elsewhere, such as with respect to partner-level adjustments under Section 743(b).[113]

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[112] 84 Fed. Reg. 8190.

[113] *See, e.g.*, Prop. Treas. Reg § 1.163(j)-6(d)(2).

H. Applicability Dates

The documentation requirements in the Proposed Regulations are proposed to apply to taxable years ending on or after March 4, 2019.[114] The Proposed Regulations recognize that the documentation requirements may apply to transactions that have occurred before their issuance and taxpayers may not be able to obtain the documentation required for transactions that have already been completed. Accordingly, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer's business that establishes that a recipient is a foreign person, property is for foreign use or a recipient of a general service is located outside the United States, provided such documentation otherwise meets the reliability requirement.[115]

Given that many taxpayers may have entered into long-term contractual relationships with third parties that do not contemplate the sharing of information for purposes of complying with the documentation and determination rules, and the significant procedural and reporting burdens that may accompany the documentation of foreign use, we recommend that taxpayers be given a longer transition period to comply with the documentation rules. As proposed, calendar year taxpayers would have only nine months to implement significant changes in information collection and reporting of their sales. A longer transition period would ease the cost of complying with the documentation requirements described by the Proposed Regulations, especially as they are not yet in final form.[116] We urge Treasury to consider revising the applicability date so that the documentation rules will apply as of the second anniversary of the date the regulations are finalized.

In addition, Treasury should consider allowing the transitional documentation rules to continue to apply to sales or other transactions pursuant to contracts entered into on or prior to March 4, 2019 and that have not been subject to a material modification after March 4, 2019, for an additional period of two to three years beyond the applicability date of the final regulations (depending perhaps on the applicability date of the final regulations). Long-term contracts are likely to be particularly difficult and expensive for a U.S. seller to modify. Providing taxpayers that are parties to long-term contracts some reasonable period of time to renegotiate and request documentation of foreign use could help reduce the incremental costs to U.S. sellers. We believe that if a

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[114] Prop. Treas. Reg. § 1.250-1(b).

[115] *Id*.

[116] In many cases, the Proposed Regulations would require parties to amend their contracts to provide for the collection of information necessary to document the foreign use of goods or services. Parties will not wish to do so until the Regulations are finalized, to avoid the risk of having to modify their important agreements several times as the Regulations are modified.

contract provides for the parties to periodically alter the pricing or type of goods sold under the contract, any such changes should be considered a material modification for this purpose.