

# The Relaxed FDII Documentation and Transition Rules Don't Stop Giving

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In this article, the author summarizes the final section 250 regulations recently released by Treasury to provide guidance on the deduction for foreign-derived

intangible income introduced by the Tax Cuts and Jobs Act.

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On March 5, 2019, the U.S. Treasury issued proposed regulations under section 250 (REG-104464-18) that provided guidance for determining the amount of the deduction for foreign-derived intangible income. Importantly, the proposed regs identified the documentation that taxpayers were required to have by the FDII filing date<sup>1</sup> to secure their FDII deductions.

The U.S. tax community widely and loudly criticized the proposed regulations' documentation requirements, which in large part required the cooperation of an unrelated counterparty that was under no legal obligation to provide documentation and would derive no

benefit from doing so. In the absence of that documentation, the taxpayers' deduction would be denied, and the vitality of the FDII regime was at risk of losing its vitality.

On July 9 Treasury issued final section 250 regulations (T.D. 9901). Thankfully, it heard the U.S. tax community's complaints and significantly relaxed the FDII documentation and substantiation requirements.

First, and importantly, the final regulations completely eliminate the proposed regulations' requirement to obtain documents to establish the end-user's status as a foreign person, the foreign use of some general property for sales made directly to end-users, and the location of general services provided to consumers. That said, the government has emphasized that, as with any deduction, taxpayers claiming a section 250 deduction bear the burden of demonstrating that they are entitled to it.

The final regulations also adopt a much more flexible approach regarding the types of substantiation required for foreign use for sales of general property to non-end-users, foreign use for sales of intangible property, and determining whether services are performed for business recipients outside the United States. However, the final regs continue the proposed regulations' requirement that substantiating documents be supported by credible evidence.

Finally, and also of import, the regulations' applicability dates have been revised, with taxpayers permitted to rely on the proposed regulations for tax years before the final regulations are applicable, including relying on transition rules during that entire period. In short, that means that calendar-year taxpayers can use any reasonable documentation maintained in the ordinary course through 2020.

<sup>1</sup>For a sale of property by a seller or provision of service by a renderer, the term "FDII filing date" means the date, including extensions, by which the seller or renderer must file an income tax return for the tax year in which the gross income from the sale or provision is included in the seller or renderer's gross income.

## I. FDDEI for Sales

### A. Presumption of Foreign Person Status

Under the final regulations, the sale of property is presumed to be to a foreign recipient:

- if the sale is a foreign retail sale;
- in a non-retail sale of general property to a recipient or end-user, if the shipping address of the recipient or end-user is outside the United States;
- for all other sales of general property, if the recipient's billing address is outside the United States; and
- in a sale of intangible property, if the recipient's billing address is outside the United States.

However, those presumptions do not apply if the seller knows or has reason to know that the sale is not to a foreign person.<sup>2</sup>

### B. Determining Foreign Use

#### 1. General Property

In general, a sale of general property delivered through a carrier or freight forwarder to a recipient that is an end-user is for foreign use if the end-user receives delivery of the general property outside the United States.<sup>3</sup> If the general property is not delivered through a carrier or freight forwarder, the sale is for a foreign use if the property is outside the United States at the time of sale.

A sale of general property to a recipient that will sell the general property (such as a distributor or a retailer) is for foreign use if the property will ultimately be sold to end-users outside the United States and those sales to end-users are substantiated.

A sale of general property that primarily contains digital content that is transferred electronically is for a foreign use if the end-user downloads, installs, receives, or accesses the purchased content on its device outside the United States. If information about where the digital content is downloaded, installed, received, or accessed is unavailable and the gross receipts from all sales to the end-user (which may be a business) are less than \$50,000, the sale is for a foreign use if the end-user has a billing address outside the United States.<sup>4</sup>

A sale of general property is for a foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing<sup>5</sup> outside the United States and that activity is substantiated.

General property is a component that is incorporated into another product if the incorporation involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances. However, general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. General property is treated as a component if, using reliable estimates, the seller expects that the component's fair market value (when delivered to the recipient) will constitute no more than 20 percent of the FMV of the finished good when sold to the end-user (the 20 percent rule).<sup>6</sup>

If the seller sells general property to a recipient (other than a related party) for manufacturing, assembly, or other processing in

<sup>4</sup>Treas. reg. section 1.250(b)-4(d)(1)(ii)(D). Rules for international transportation property can be found in Treas. reg. section 1.250(b)-4(d)(1)(ii)(E) and (F).

<sup>5</sup>Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed or is incorporated as a component into another product.

Determining whether general property is subject to physical and material change is based on all the relevant facts and circumstances. General property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state.

<sup>6</sup>For the 20 percent rule, all general property sold by the seller and incorporated into the finished good is treated as a single item of property if the seller sells it to a recipient and knows or has reason to know the components will be incorporated into a single item of property (for example, multiple components sold as a kit).

<sup>2</sup>A seller has reason to know that a sale is not to a foreign person if the information received as part of the sales process contains information indicating that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. Information that indicates an individual recipient is not a foreign person includes a U.S. phone number, billing address, shipping address, or place of residence; and, for an entity, evidence that the entity is incorporated, formed, or managed in the United States.

<sup>3</sup>That kind of sale is not treated as a sale to an end-user for foreign use if it is made with a principal purpose of having the property transported from outside the United States to within the United States for ultimate use or consumption.

the United States, that property is not sold for a foreign use even if the other requirements are met.

## 2. Intangible Property

A sale of rights to exploit intangible property solely outside the United States is a sale for foreign use. Conversely, a sale of rights to exploit intangible property solely in the United States is not a sale for foreign use. A sale of rights to exploit intangible property worldwide is a sale partially for foreign use and partially not for foreign use.

A sale of rights to exploit intangible property both in and outside the United States is for foreign use in the proportion to the revenue earned from end-users outside the United States over the total revenue earned from the exploitation of the intangible property. A sale of intangible property will be treated as a foreign-derived deduction-eligible income (FDDEI) sale only if the substantiation requirements are met.

If intangible property is embedded in general property, or is used in connection with a sale of general property, the end-user of the intangible property is the end-user of the general property.

If intangible property is used to provide a service, the end-user of that intangible property is the recipient, consumer, or business recipient of the service. For a property service, the end-user is the owner of the property on which service is being performed.

If intangible property consists of a manufacturing method or process and is sold to a foreign unrelated party (including in a sale by a foreign related party), the foreign unrelated party is treated as an end-user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end-user in the United States.<sup>7</sup>

If intangible property (the primary property) is used to develop new or modify other intangible property (the secondary property), the end-user

of the primary property is the end-user of the secondary property.<sup>8</sup>

## C. Foreign Use Substantiation

As noted, a sale of property qualifies as an FDDEI transaction only if the taxpayer satisfies the substantiation requirements. In general, the substantiation rules require that the substantiating documents exist by the time the taxpayer files its return (including extensions) for the FDDEI transaction — that is, by the FDII filing date.

The final regulations do not impose additional requirements regarding when substantiating documents must be in existence. However, the timing of the creation of substantiating documents might affect the credibility of those documents. For example, documents created at or near the time of the transaction generally have a higher degree of credibility than those created later. For long-term contracts, substantiating documents created when the transaction was entered into will be more credible in later years if the taxpayer periodically confirms that the contract terms are being adhered to.

Under the final regs, substantiating documents must be provided to the IRS on request, generally within 30 days or another period agreed to by the IRS and the taxpayer.<sup>9</sup> According to the preamble, that is necessary to allow the substantiation requirements to serve their purpose, including to allow the IRS to timely examine the taxpayer's qualification for the FDII deduction.

### 1. General Property

A seller satisfies the substantiation requirements for the sale of general property for resale only if it maintains at least one of the following:

<sup>8</sup> Treas. reg. section 1.250(b)-4(d)(2)(ii)(D). Treas. reg. section 1.250(b)-4(d)(2)(iii)(A) and (B) provides rules for determining revenue when the sale of intangible property is in exchange for periodic payments or a lump sum.

<sup>9</sup> See Treas. reg. section 1.250(b)-3(f)(1). For final rules with no specific substantiation requirements, under section 6001, taxpayers must file returns, render statements, and keep the necessary records to show whether they are liable for tax. Therefore, a taxpayer claiming a deduction under section 250 will still be required to substantiate that it is entitled to the deduction even if it is not subject to the specific substantiation requirements in the final regulations. See *INDOPCO v. Commissioner*, 503 U.S. 79, 84 (1992) ("an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer" (internal citations omitted)).

<sup>7</sup> A sale of intangible property consisting of a manufacturing method or process (including a sale by a foreign related party) to a foreign unrelated party for use in manufacturing products for or on behalf of the seller or any person related to the seller does not qualify as a sale to a foreign unrelated party for purposes of determining the end-user.

- a binding contract that specifically limits subsequent sales to those outside the United States;
- proof that the property is specifically designed, labeled, or adapted for a foreign market;
- proof that the cost of shipping the property back to the United States relative to the property's value makes it unlikely that the property will be resold in the United States;
- credible evidence obtained or created in the recipient's ordinary course of business evidencing the property will be sold to an end-user outside the United States; or
- a written statement by the seller containing the following information corroborated by credible and sufficient evidence:
  - the recipient's name and address;
  - the date(s) the property was shipped or delivered to the recipient;
  - the gross income from the sale;
  - a description of the property subject to resale;
  - a description of the method of sale to end-users, such as direct sales by the recipient or sales by it to retail stores;
  - a description of the end-user, if known; and
  - a description of how the seller determined that the property will be ultimately sold to an end-user outside the United States (or, in sales of fungible mass property, of how the taxpayer determined what portion of the property will ultimately be sold to end-users outside the United States).

A seller satisfies the substantiation requirement for a sale of general property subject to manufacturing, assembly, or other processing outside the United States if it maintains at least one of the following:

- credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and generally cannot be sold to end-users without being subject to a physical and material change (for example, the sale of raw materials that cannot be used except in the manufacturing process);
- credible evidence obtained or created in the recipient's ordinary course of business to support that the product purchased will be

- subject to manufacture, assembly, or other processing outside the United States; or
- a written statement by the seller containing the following information that is corroborated by credible and sufficient evidence:
  - the name and address of the manufacturer of the property;
  - the date(s) the property was shipped or delivered to the recipient;
  - the gross income from the sale;
  - a description of the general property sold and the type(s) of finished goods that will be incorporated into it;
  - a description of the manufacturing, assembly, or other processing operations, including the location(s) of manufacture, assembly, or other processing; how the general property will be used in the finished good; and the nature of the finished good's manufacturing, assembly, or other processing operations as compared with the process to make the general property used in the finished good;
  - a description of how the seller determined that the general property was substantially transformed or that the activities were substantial; and
  - if the seller is relying on the 20 percent rule, an explanation of how it satisfies the rule.

## 2. Intangible Property

A taxpayer satisfies the substantiation requirements for a sale of intangible property for foreign use if it maintains at least one of the following:

- a binding contract that specifically provides that the intangible property can be exploited solely outside the United States;
- credible evidence obtained or created in the recipient's ordinary course of business establishing the portion of the revenue for a tax year that was derived from exploiting the property outside the United States; or
- a written statement by the seller containing the following information that is corroborated by credible and sufficient evidence:
  - the recipient's name and address;



- the date of the sale;
- the gross income from the sale;
- a description of the property;
- an explanation of how the recipient will use the property (embedded in general property, used to provide a service, used as manufacturing method or process, or used in research and development);
- an explanation of how the seller determined what portion of the sale is an FDDEI sale;
- if the intangible property consists of a manufacturing method or process, an explanation of how the elements of foreign use are satisfied;
- if the sale is for periodic payments, an explanation of how the seller determined the extent of foreign use based on the recipient's actual revenue from using the property for the tax year in which a periodic payment is received, or, if actual revenue cannot be obtained after reasonable efforts, an explanation of why actual revenue is unavailable and how the seller determined the extent of foreign use based on estimated revenue; and
- if the sale is for a lump sum, an explanation of how the seller determined the total net present value of revenue it expected to earn from exploiting the property outside the United States and the total net present value of revenue it expected to earn from exploiting the property.

## II. FDDEI for Services

In general, the term "FDDEI service" means the provision of a general service to a consumer or business recipient outside the United States; a proximate service to a recipient outside the United States; a property service for tangible property outside the United States; or a transportation service to a recipient, or for property, outside the United States.<sup>10</sup>

<sup>10</sup> This article discusses only the provision of general services. Treas. reg. section 1.250(b)-5(f) provides rules on the provision of proximate services; reg. section 1.250(b)-5(g) provides rules regarding the provision of property services; reg. section 1.250(b)-5(h) provides rules regarding the provision of transportation services; and reg. section 1.250(b)-6 provides rules on related-party transactions.

## A. General Services Provided to Consumers

In general, a general service is provided to a consumer outside the United States if the consumer resides outside the United States when the service is provided. If after reasonable efforts the service provider (the renderer) does not have or cannot obtain the consumer's location when the service is provided, the consumer is treated as residing at its billing address. That rule of convenience does not apply if the renderer knows or has reason to know that the consumer does not live outside the United States.<sup>11</sup>

The consumer of an electronically supplied service is deemed to reside at the location of the IP address when the service is provided. However, if after reasonable efforts the renderer does not have or cannot obtain the consumer's device location, the location of the device is treated as being outside the United States if the consumer's billing address is outside the United States, subject to the knowledge and reason to know standards.

## B. General Services to Business Recipients

In general, a general service is provided to a business recipient outside the United States if the service benefits the recipient's operations outside the United States. The location of residence, incorporation, or formation of a business recipient is not relevant to determining the location of the business recipient's operations.

In general, determining which and to what extent non-U.S. operations benefit from a general service follows the principles of Treas. reg. section 1.482-9. The taxpayer is treated as one controlled taxpayer, any portion of the business recipient's operations in the United States that may benefit from the general service is treated as at least one controlled taxpayer, and each portion of the recipient's non-U.S. operations that may benefit from the general service is treated as at least one controlled taxpayer.<sup>12</sup>

The extent to which a business recipient's operations in or outside the United States are

<sup>11</sup> A renderer has reason to know that the consumer does not reside outside the United States if the information received as part of the provision of the service indicates that the consumer resides in the United States and the renderer fails to obtain evidence establishing that is not the case.

<sup>12</sup> Treas. reg. section 1.250(b)-5(e)(2)(i).

treated as one or more separate controlled taxpayers is determined under any reasonable method — for example, separate controlled taxpayers may be determined on a per-entity or per-country basis, or by aggregating all the recipient's operations outside the United States into one controlled taxpayer.

Determining the benefit conferred on the business recipient's operations that is treated as a controlled taxpayer is determined in a reasonable method consistent with the rules of Treas. reg. section 1.482-9(k) — that is, treating the renderer's gross income from the services provided to the business recipient as if it were a Treas. reg. section 1.482-9(k) cost.<sup>13</sup> Reasonable methods include allocations based on the renderer's time spent or costs incurred or the recipient's sales, profits, or assets. The determination is made when the service is provided based on information obtained from the business recipient or in the renderer's records (such as the time spent working with the business recipient's non-U.S. offices).

### 1. Ads and Electronically Supplied Services

The operations of a business recipient that benefit from advertising services are deemed located where the advertisements are viewed by individuals. If advertising services are displayed via the internet, they are viewed where the viewing is located, which the IP address may be used to establish.

The operations of the business recipient that benefit from an electronically supplied service are deemed located where the recipient (including employees, contractors, or agents) accesses the service. If it cannot be determined whether the location is in or outside the United States (such as when the location of access cannot be reliably determined using the IP address of the device used to receive the service), and the gross receipts from all services for the business recipient are less than \$50,000 for the renderer's tax year, the operations that benefit from the service are deemed located at the recipient's billing address. If the recipient's benefiting operations are partially a general service that is not an electronically supplied service (such as a service

that is performed partially online and partially by mail or in person), the recipient's location is determined using the rule for electronically supplied services if the primary purpose of the service is to provide electronically supplied services; otherwise, the rule for general services applies.<sup>14</sup>

### 2. Substantiation

Except for specific loss transactions, a general service provided to a business recipient is treated as an FDDEI service only if the renderer substantiates its determination of the extent to which the service benefits a business recipient's operations outside the United States by maintaining at least one of the following:

- credible evidence obtained or created in the ordinary course of business establishing the extent to which the recipient's operations outside the United States benefit from the service; or
- a written statement by the renderer containing the following information that is corroborated by credible and sufficient evidence:
  - the recipient's name;
  - the date(s) of service;
  - the gross income from the service;
  - a description of the service;
  - a description of how the service will benefit the business recipient; and
  - an explanation of how the renderer determined what portion of the service would benefit the business recipient's operations outside the United States.

The final regulations include a substantiation exception for small businesses similar to that in the proposed regulations. It provides that the requirements do not apply if the taxpayer and all related parties in the aggregate have less than \$25 million in gross receipts during the prior tax year. In response to comments that the small business exception should be broader, the final regulations modified the threshold amount from \$10 million of gross receipts for the seller of general property or renderer of services in the prior tax year.

<sup>13</sup> *Id.*

<sup>14</sup> Treas. reg. section 1.250(b)-5(e)(2)(iii). Treas. reg. section 1.250(b)-5(e)(3) provides rules regarding the identification of the business recipient's operations.

Although a small business will not need to satisfy the specific substantiation requirements in the regulations, it still must continue to comply with the general substantiation rules under section 6001. For example, small businesses may be able to substantiate that a sale of general property is for foreign use by using evidence of a foreign shipping address and memorializing conversations with the recipients explaining where the property will be resold (if sufficiently reliable) or having a copy of an export bill of lading.

### III. Transition Rule

Under the proposed transition rule, for tax years beginning on or before March 4, 2019, taxpayers could use any reasonable documentation maintained in the ordinary course of business that established that a recipient was a foreign person, property was for a foreign use, or a recipient of a general service was located outside the United States, in lieu of the specific documentation described in the regulations if it met the reliability requirements.

Comments recommending making the transition rule permanent indicated that the documentation described in the proposed regulations might be difficult, if not impossible, to

obtain in the ordinary course of business. Other comments requested extending the rule for a specific period, saying that would allow adequate time for the IRS to gain experience with the types of documentation taxpayers collect in the ordinary course of business and for taxpayers to gain experience complying with the rules by developing or improving internal compliance systems.

The final rules amended the applicability dates to give taxpayers additional time to develop systems for complying with the final regulations. Now, they generally apply for tax years beginning on or after January 1, 2021. According to the preamble, that ensures that all taxpayers, regardless of whether they are fiscal- or calendar-year taxpayers, have at least three full tax years after enactment of the Tax Cuts and Jobs Act before the final regulations become applicable.

For tax years beginning before January 1, 2021, taxpayers may apply the final regulations or rely on the proposed regulations; however, taxpayers that choose the second option may rely on the transition rule for documentation for all tax years beginning before January 1, 2021.

Thus, the revised transition rule does not stop giving! ■