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Client Alert
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Treasury and the IRS Release Final FDII Regulations

Introduction

On July 9, 2020, Treasury and the IRS issued Final Regulations (the "Final Regulations") relating to the Code Section 250 deduction for foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI"). The Final Regulations follow Proposed Regulations released in March 2019 (the "Proposed Regulations"). While the Final Regulations retain the basic approach and structure of the Proposed Regulations, Treasury and the IRS made significant changes, mostly taxpayer favorable, that are discussed herein.

This Client Alert provides a high-level overview of the FDII deduction and the Proposed and Final Regulations, notes areas of substantial departure from the Proposed Regulations, and discusses issues most concerning to taxpayers, in particular the documentation requirements.

The Purpose of FDII: Ensuring Tax Parity for Intangible Income

Congress intended the FDII deduction to create parity for domestic corporations that sell into foreign markets and earn FDII directly, rather than through controlled foreign corporations ("CFCs"). In effect, the FDII deduction is meant to provide tax neutrality for taxpayers' decisions where to locate and exploit intangible property and through what type of entity.

Section 250 provides a 37.5% deduction against a domestic corporation's FDII. FDII is the portion of a domestic corporation's intangible income, determined formulaically, that is derived from serving foreign markets. FDII equals the product of a domestic corporation's "deemed intangible income" ("DII") and the ratio of the corporation's "foreign-derived deduction eligible income" ("FDDEI") to the corporation's "deduction eligible income" ("DEI").

> **Observation: The 37.5% deduction creates an effective tax rate on a corporation's FDII of 13.125% thereby providing rough parity to the GILTI break-even point (foreign effective tax rate of 13.125% or higher, 50% GILTI deduction and 20% haircut of the foreign tax credit). The FDII deduction provides not only a cash tax benefit, but also an effective tax rate (ETR) benefit (i.e., a permanent difference) resulting, in some cases, in as much as a five-percentage point reduction in the ETR.**

The foundations of the FDII calculation, then, are DII, and the ratio of FDDEI to DEI. DII means DEI less a deemed 10% return on the domestic corporation's tangible assets ("DTIR"). DEI is the domestic corporation's gross income with certain exclusions ("Gross DEI"), reduced by deductions (including taxes) "properly allocable" to that gross income. Section 250 excludes from Gross DEI certain items of gross income (subpart F income, GILTI, financial services income, foreign branch income, and domestic oil and gas extraction income). The statute does not provide an allocation method for deductions, and the legislative history notes only that allocable deductions "encompass all deductions (including taxes) properly allocable to deduction eligible gross income."

The numerator of the ratio, FDDEI, is DEI derived in connection with either (i) property sold by the taxpayer to any person who is not a United States person that the taxpayer "establishes to the satisfaction of the Secretary is for a foreign use" or (ii) income derived in connection with services provided to any person, or for property, which the taxpayer establishes to the satisfaction of the Secretary is not located within the United States. The proposed and final rules refer to these transactions individually as "FDDEI Sales" and "FDDEI Services" and collectively as "FDDEI transactions." The terms "sold," "sells," and "sale" should be read as including any lease, license, exchange, or other disposition. "Foreign use" is defined as "any use, consumption, or disposition which is not within the United States."

Key Changes in the Final Regulations

The statute requires the taxpayer to "establish to the satisfaction of the Secretary" that it has satisfied the requirements related to foreign person/foreign use (for sales) and non-U.S. location (for services). The Final Regulations significantly relax the rigorous documentation rules in the Proposed Regulations, providing taxpayers greater flexibility to establish "foreign use," foreign person, and location.

The Proposed Regulations adopted a rigorous documentation standard, which would have required many taxpayers to make significant changes to their commercial arrangements with third parties and related parties. Specifically, it provided that to establish that a recipient is a foreign person, that property is for a foreign use, or that a recipient of a general service is located outside the United States, the taxpayer must obtain and retain specific types of documentation that are not kept in the ordinary course of a taxpayer's business. Further, the documentation obtained by the taxpayer had to comply with additional requirements intended to corroborate the reliability of the documentation, including that the documentation be obtained no later than the "FDII filing date" and no earlier than one year before the date of the relevant sale or service. To provide taxpayers some relief from these burdensome rules, the Proposed Regulations included several exceptions to the general documentation requirements and a transition rule under which taxpayers could use any reasonable documentation maintained in the ordinary course of business for tax years beginning on or before March 4, 2019.

Numerous commenters noted that requiring taxpayers to create or collect such documentation would be burdensome. Customers would be highly reluctant to provide it, and in some cases, taxpayers would be required to renegotiate contracts, disrupting the business relationship.

In response to these comments, the Final Regulations, broadly speaking, adopted a more flexible approach for the required substantiation. For sales of general property or inventory, the Final Regulations provide for a general presumption of foreign person status based on shipping documentation. In eliminating specific documentation requirements, Treasury and the IRS, in the Preamble to the Final

Regulations, stated the general duty of taxpayers to maintain reasonable records to substantiate a deduction under section 6001 and cases such as *INDOPCO v. Commissioner*, 503 U.S. 79, 84 (1992) (". . . the burden of clearly showing the right to the claimed deduction is on the taxpayer."). The Final Regulations impose specific substantiation rules in three cases: for foreign use regarding sales of general property to non-end users, for sales of intangible property, and for determining whether services are performed for business recipients located outside the United States.

Aside from relaxing the documentation rules, the Final Regulations provide numerous changes for determining whether a transaction generates income from a FDDEI Sale or Service, including, but not limited to: (1) providing a new rule for sales of general property that primarily contain digital content, (2) modifying the rule for foreign military sales, (3) expanding certain presumptions about when a sale can be considered to be made to a foreign person or for foreign use, (4) revising the rules for sales of international transportation property, (5) adding a rule for a sale or license of bundled IP, (6) clarifying the term "benefit" for purposes of determining whether income from a service is foreign-derived, and (7) allowing certain property services to be treated as FDDEI Services where the service is provided in the United States. In addition, the Final Regulations adopt a consistent definition of foreign branch income for purposes of FDII and the foreign tax credit, which allows gain from such a sale of a disregarded entity to be included in DEI and FDDEI. The Final Regulations made favorable changes to the partnership tax rules, which broadly speaking allow domestic corporate partners to include their share of the partnership's items of gross DEI, gross FDDEI, and related deductions for purposes of calculating their FDII amount. We discuss each change, in turn, below.

The Final Regulations are generally applicable to tax years beginning on or after January 1, 2021, which provides taxpayers more time to adjust their systems and documentation protocols.

FDDEI Sales of General Property: Foreign Use and Foreign Person Rules

A "FDDEI Sale" includes a sale of general property to a foreign person for a foreign use. The terms "sold," "sells," and "sale" should be read as including any lease, license, exchange, or other disposition. The Final Regulations define "general property" to mean any property other than intangible property, a security, an interest in a partnership, trust, or estate, or certain commodities. The Final Regulations clarify that general property also includes "digital content" as defined by the regulations.

The foreign use and foreign person rules generally apply for a variety of property transactions. In general, "foreign use" is defined as "any use, consumption, or disposition which is not within the United States." The regulations use an "end user" concept - not found in the statute - as a means for determining whether a sale of general property or intangible property is for a foreign use; in this context, an end user is the person that ultimately uses the property in question. A person who acquires property for resale, or otherwise as an intermediary, is generally not an end user, with certain exceptions.

Foreign Use: Four Categories

The Final Regulations provide that a sale of general property is for a foreign use if the seller determines that the sale is to an "end user" in a specified set of circumstances. These categories include (1) sales delivered to an end user by a carrier or freight forwarder, (2) sales to an end user without the use of a carrier or freight forwarder, (3) sales for resale, and (4) sales of digital content. Sales to end users, with delivery by a carrier or freight forwarder, are generally treated as for a foreign use if the end user receives delivery of general property outside the United States. Sales to end users without the use of a carrier or freight forwarder are for foreign use if the property is located outside the United States at the time of sale. For sales for resale, the Final Regulations provide that a sale of general property to a reseller (e.g., a distributor or retailer), is considered to be for a foreign use if (i) the property will ultimately be sold to end users outside the United States and (ii) such sales are properly substantiated.

Sale of Property for Manufacture, Assembly, or Processing

The Final Regulations provide special rules for sales of property to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the United States. Deviating from the general end user approach, the Final Regulations clarify that a property sale under these circumstances will qualify as sold for foreign use regardless of whether the resulting property is subsequently sold within the United States (the "Manufacturing Exception"). Conversely, if the property is subject to manufacture, assembly, or other processing within the United States and is subsequently resold for foreign use, the property will not be treated as sold for a foreign use.

Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (the "Physically and Materially Changed Test") or the property is incorporated as a component into another product (the "Component Test"). General property meets the Physically and Materially Changed Test if, based on the relevant facts and circumstances, the general property is substantially transformed and is distinguishable from and cannot be readily returned to its original state.

The Component Test is satisfied if the incorporation of the general property into another product involves activities that are substantial in nature and is generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances. To meet this test, the general property must be subject to more than packaging, repackaging, labeling, or minor assembly operations. Significantly, the Final Regulations convert into a safe harbor the proposed rule that requires the fair market value of the component when it is delivered to the recipient to constitute no more than 20 percent of the fair market value of the second product that includes the component. The Final Regulations further revise this 20 percent safe harbor by providing that the comparison is between the fair market value of the component sold to the manufacturer and the fair market value of the finished goods sold to consumers (or a representative sample if the property is incorporated into multiple finished goods), rather than the second product (which could itself be an unfinished good).

Sales of Digital Content

The Preamble notes that the rules governing the sales of physical general property are not generally applicable for sales of digital content, including copyrighted articles transferred electronically. Accordingly, the Final Regulations introduce an additional rule for sales of general property that primarily contain digital content. "Digital content" is defined as a computer program or any other content in digital format. This may include, for example, books, movies, and music in digital format. A computer program may include user manuals, documentation, data bases, or other similar items that are incidental to the operation of such computer program.

> **Observation: In general, the principles that classify transactions in computer programs under Treas. Reg. § 1.861-18 now will apply for purposes of distinguishing between transactions in general property and intangible property under the FDII rules.**

> **Observation: Similarly, the proposed -18 regulations, issued in August 2019, are expressly made applicable to section 250. The Preamble to the Final Regulations noted that no inference is intended for the treatment of sales of copyrighted articles under other sections of the Code.**

Under the new rule, digital content that is transferred electronically, rather than in a physical medium, is for a foreign use if the end user downloads, installs, receives, or accesses the purchased digital content on the end user's device outside the United States. If this information is unavailable, a sale of this general property is for a foreign use if (1) the sale is to an end user that has a billing address located outside the United States and (2) the gross receipts from all sales to the end user are less than $50,000.

> **Observation: The definition of "digital content" includes a reference to "any media, user manuals, documentation, data base, or other similar item if [such item] is incidental to the operation of the computer program". However, the foreign use rule for sales of "digital content" expressly refers to sales of content that is transferred electronically rather than in a physical medium. The apparent result is the rules for foreign use are different for digital content delivered electronically and digital content delivered on tangible media.**

In one example in the Final Regulations, DC sells copyrighted music available for download on its website. Once downloaded, the recipient listens to the music on electronic devices that do not need to be connected to the internet. DC has data that an individual accesses the website to purchase a song for download on a device located outside the United States. The terms of the sale permit the recipient to use the song for personal use, but convey no other rights to the copyrighted music to the recipient. Under the Final Regulations, the sale is considered for a foreign use because the supplier "has data" that the user accessed the website for download onto a device located outside the United States. The reference to "data" demonstrating the foreign use seems to indicate that taxpayers have some flexibility to demonstrate the foreign use of copyrighted articles via means of proof other than IP addresses.

The Final Regulations clarify that, for purposes of section 250, copyrighted articles are excluded from the definition of intangible property, and thus are treated as general property. These rules, however, do not provide guidance regarding the character of a transfer of a copyrighted article as a sale or a service, but defer to general U.S. tax principles, taking into account the regulations issued under section 861.

Related Party FDDEI Sales

The Final Regulations make several helpful changes to the rules for determining when the sale of property by a domestic corporation to a foreign related party could constitute FDDEI Sales.

First, the Proposed Regulations provided that a domestic corporation could not treat the related party sale as a FDDEI Sale until an unrelated sale occurred. In particular, if the unrelated sale did not occur until after the FDII filing date for the related party sale, then the domestic corporation would have to file an amended return to claim any additional FDII benefit resulting from treating the related-party sale as a FDDEI Sale. Recognizing the administrative burdens associated with this approach, the Final Regulations remove the "amended return requirement" and provide that the domestic corporation can treat a related party sale as a FDDEI Sale if it can substantiate that an unrelated sale "will occur" for the property sold in the related party sale.

Second, where a foreign related party purchases property in a related party sale and then uses the property to produce other property sold to unrelated parties or to provide services to unrelated parties in FDDEI transactions (unrelated transactions), the Proposed Regulations provided that the related party sale could be treated as a FDDEI Sale but only if more than 80% of the foreign related party's revenue derived from the sale of the property purchased will be earned from unrelated transactions. Recognizing the potential for a cliff effect, the Final Regulations remove the 80% threshold and provide that such a related party sale can be treated as a FDDEI Sale to the extent that the domestic corporation "reasonably expects" the revenue for the property purchased to be earned from unrelated transactions.

Intangible Property: Foreign Use Rules

The Final Regulations generally retain the proposed rule that a sale of intangible property is for a foreign use to the extent it generates revenue from exploitation outside the United States. The general rule in the Final Regulations is that intangible property is exploited at the location of the end user. A sale of rights to exploit intangible property solely outside the United States is for a foreign use, and a sale of rights to exploit intangible property solely within the United States is not for a foreign use. Sales of rights to exploit intangible property both within and without the United States are for a foreign use in proportion to the revenue earned from end users located outside the United States over the total revenue earned from exploitation of the intangible property. The term "intangible property" for these purposes takes the extensive definition set forth under section 367(d)(4). Removing some confusion created by the Proposed Regulations, the Final

Regulations provide that for purposes of section 250, "intangible property" does not include a copyrighted article as defined in Treas. Reg. § 1.861-18(c)(3).

> **Observation: As part of the Tax Cuts and Jobs Act, it should be noted that Congress expanded the definition of "intangible property" under section 367(d) to include any goodwill (both foreign and domestic), going concern value and workforce in place, as well as any "other item the value or potential value of which is not attributable to tangible property or the services of any individual."**

Despite comments, the Final Regulations do not allow look-through treatment for global licensing transactions in which a U.S. taxpayer licenses intangible property to an unrelated U.S. entity that in turn sublicenses the intangible property to its foreign affiliates. The absence of a look-through rule in these cases creates an asymmetry between certain transactions that arguably should be economically similar (e.g., global enterprise licenses subject to the FDDEI Sales rules and software-as-a-service arrangements subject to the FDDEI Services rules).

The Final Regulations provide specific rules for sales of intangible property in various circumstances, discussed in more detail below.

Embedded or Associated IP

The Final Regulations clarify that when intangible property is embedded in or used in connection with the sale of general property, the end user of the intangible property is assumed to be the end user of the general property. Accordingly, the sale or license of intangible property will be for a foreign use to the same extent that the sale of the general property incorporating the intangible property would be for a foreign use under the rules applicable to sales of general property.

Intangible Property Used to Provide a Service

In response to comments on the Proposed Regulations, the Final Regulations provide that the end user of intangible property that is used to provide a service is the recipient, consumer, or business recipient of the service. The intangible property sale is for a foreign use only to the extent that the provision of the service would qualify as a FDDEI Service under Treas. Reg. § 1.250(b)-5. Thus, if the recipient uses the intangible property to perform a property service that qualifies as a FDDEI Service to another person, the end user is treated as located outside the United States.

Process IP

The Final Regulations fill a gap left in the Proposed Regulations by providing a rule for a "manufacturing method or process." If the intangible property is sold or licensed to a foreign unrelated party for use outside the United States, the foreign unrelated party is treated as an end user for determining foreign use, even if the manufactured product is ultimately sold to persons within the United States ("process IP exception"). However, the recipient is treated as an end user located in the United States if the seller knows or has reason to know that the intangible property will be used in the United States.

The process IP exception is subject to other important limitations. A "manufacturing method or process" is defined narrowly as "a sequence of actions or steps that comprise an overall method or process that is used to manufacture a product or produce a particular manufacturing result, which may be in the form of a patent or know-how." Therefore, the process IP exception would not apply to the sale or license of typical make-sell rights to a foreign unrelated party—it applies only to the sale of knowledge of the method or process itself. The process IP exception also does not apply to a sale of intangible property to any related party or to a foreign unrelated party for use in manufacturing products for or on behalf of the seller or a related party. The prohibition encompasses contract or toll manufacturing arrangements. Notably, the process IP exception is not available for IP that is used to provide a service.

R&D IP

The Final Regulations provide that, if intangible property ("primary IP") is sold for use in the development of other intangible property ("secondary IP"), the end user of the primary IP is the end user of the secondary IP, as determined under the rules described above.

Revenue and the Extent of Foreign Use

Under the Final Regulations, whether intangible property is transferred in exchange for periodic payments or a lump sum determines the standard for establishing the extent of foreign use. If intangible property is sold to an unrelated recipient in exchange for periodic payments, the extent to which the sale is for a foreign use must be determined annually based on the actual revenue earned by the recipient from any use of the intangible property during the taxable year in which a periodic payment is received. Significantly, if there is a periodic payment in a year when the intangible property does not actually produce revenue, then no portion of the intangible property is treated as having a foreign use in that year. In the likely event that the seller cannot obtain actual revenue amounts after reasonable efforts, then the seller may estimate revenue by reference to principles of the lump sum rule.

If the intangible property is sold to an unrelated recipient for a lump sum amount, the seller determines foreign use based on the ratio of the seller's total expected net present value of revenue from exploitation of the intangible property outside the United States to the seller's total expected net present value of revenue from exploitation of the intangible property worldwide. Alternatively, the seller may use net present values of revenue the recipient expected to earn, at the time of the sale, from exploitation of the intangible property within and without the United States.

Special rules apply to sales of manufacturing methods or processes (discussed above). In these sales, the end user revenue is the amount the recipient of the manufacturing method or process receives from its end users. If the manufacturing method or process is bundled with other intangible property, revenue from the manufacturing method or process is the product of the total amount paid for the bundled property and the proportionate value of the manufacturing method or process relative to the total value of that property.

Foreign Use of International Transportation Property

Under the Proposed Regulations, international transportation property satisfied the foreign use requirement if two conditions were met during the three year period from the date of its delivery: (1) the property is located outside the United States more than 50% of the time, and (2) more than 50% of the miles traversed in the use of the property are traversed outside the United States. Commenters raised several objections to this rule, including that the 50% time and miles test was significantly more restrictive than the "any foreign use" requirement imposed by the statute, and sellers of international transportation property did not track their purchasers' use of the property after the sale. Accordingly, many commenters recommended that Treasury reduce the percentage threshold if it maintained a "time and miles test," change the "time and miles test" to a disjunctive "time or miles test," and reduce or eliminate the three-year measurement period. Additionally, several comments suggested that the final regulations expand the list of acceptable documents for establishing foreign use of international transportation property to include documentation created or obtained in the normal course of business, including customer invoices, foreign base of operations, foreign registration, and any other documentation establishing foreign use of the property.

In the Final Regulations, Treasury abandoned the proposed approach and adopted an entirely new rule that distinguishes between international transportation property used for compensation or hire (i.e., commercial use) and international transportation property that is not used for compensation or hire (i.e., private use). Under the new rule, sales of international transportation property for commercial use are for a foreign use if the end user registers the property with a foreign jurisdiction. Sales of international transportation property for private use are for a foreign use if (1) the end user registers the property in a foreign jurisdiction and (2) the end user hangars or stores the property primarily outside the United States.

Unfortunately, Treasury misunderstood the scope of the role that registration plays in international transportation property. In fact, for most types of international transportation property the registration jurisdiction bears no relationship to the use of the property. Many foreign purchasers of international transportation property register the property with the United States but use it exclusively outside the United States. For example, notwithstanding exclusive foreign use, many non-commercial aircraft owners and lessors worldwide seek registration with the United States Federal Aviation Administration to, among other things, maintain sound airworthiness standards and bolster resale value. Hangar or storage locations generally are more indicative of actual use than registration, but the logic of hangar or storage location as evidence of foreign use is negated by the conjunctive requirements for private use international transportation property. As expressed in our comments and others, we believe the better approach for private use transportation property would have been a facts-and-circumstances based analysis that considers various pieces of evidence gathered in the normal course of business, including, but not limited to, registration and hangar/storage location. Thus, in seeking an easily administrable alternative to the "time and miles test," Treasury has crafted a rule that will unintentionally exclude from FDDEI sales amounts that Congress intended to be included in FDDEI sales.

Documentation Rules for FDDEI Sales

In response to objections over the burdensome documentation rules in the Proposed Regulations, the Final Regulations in some circumstances remove the specific documentation requirements to establish foreign person status and foreign use for FDDEI Sales and the location of the recipient for FDDEI Services. In particular, changes to the specific substantiation rules allowing for the use of credible evidence obtained or created in the ordinary course of business to establish exploitation of intangible property outside the United States relieves taxpayers of the burden to create new types of information solely to substantiate foreign use of intangible property. The Final Regulations also eliminated the requirement in the Proposed Regulations that taxpayers obtain substantiating documents by the time the taxpayer files its return (including extensions) for the FDDEI transaction.

Proposed Regulations Standard

Many commenters explained that the strict documentation requirements in the Proposed Regulations were unduly onerous. These rules provided that, among other things, documentation must be obtained by the FDII filing date (generally the extended due date of the income tax return on which the section 250 deduction is claimed), no earlier than one year before the sale or service, and that the seller or provider must not know or have reason to know that the documentation is incorrect or unreliable. Beyond this, the rules included differing requirements depending on the type of transaction and provided specific lists of qualifying documentation required to support a FDII deduction.

The Proposed Regulations also provided a transition rule for taxable years beginning on or before March 4, 2019, under which taxpayers could 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 a foreign use, or a recipient of a general service is located outside the United States, as applicable, in lieu of the specific documentation described in the regulations, provided that the documentation meets certain reliability requirements. Many commenters recommended making this transition rule permanent because the documentation otherwise required may be difficult or impossible for taxpayers to collect in the ordinary course of business. As discussed below, in a move favorable for taxpayers, Treasury and the IRS considered and adopted this approach in the Final Regulations.

Final Regulations Standard

The Final Regulations replace the documentation rules for many transactions with a more flexible substantiation requirement. Specific types of documents are generally not required to establish: (1) foreign person status, (2) foreign use for sales of certain general property that are made directly to end users, and (3) the location of general services provided to consumers. For these general categories, Treasury and the IRS in the Preamble note that a taxpayer is already required under section 6001 to maintain records necessary to support deductions claimed on its return.

However, Treasury and the IRS maintain that certain categories of transactions require corroborating and credible evidence to establish that property is sold for a foreign use or that services are provided to parties located outside the United States. Thus, under the Final Regulations, specific documentation rules will still apply to the following transactions: (1) sales of general property for resale, (2) sales of general property for further manufacturing outside the United States, and (3) sales of intangible property. The final rules are more specific, albeit more flexible, than those laid out under the Proposed Regulations, and furthermore, the Final Regulations eliminated the "specific reliability" requirement found in the Proposed Regulations. Nevertheless, the Preamble indicates possible future guidance on acceptable documentation.

In response to comments regarding the small business exception laid out in the Proposed Regulations, the Final Regulations broaden this exception to provide that the substantiation requirements do not apply if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than $25 million in gross receipts during the prior taxable year. Taxpayers falling below this threshold do not need to satisfy the specific substantiation requirements in the regulations, although they must continue to comply with the general substantiation rules under section 6001**.**

For taxable years beginning before January 1, 2021, taxpayers may choose to apply either the Proposed Regulations or the Final Regulations in their entirety. The Final Regulations provide that taxpayers that choose to rely on the Final Regulations in these years do not need to comply with the specific substantiation rules described above in this section.

Taxpayers that choose to rely on the Proposed Regulations can rely on the favorable "documentation transition rule," under which a taxpayer may substantiate its FDII deduction by using any reasonable documentation maintained in its ordinary course of business. This transition rule is limited to taxable years beginning on or before March 4, 2019, however taxpayers may rely on it for all taxable years beginning before January 1, 2021.

FDDEI Services: Persons and Property Located Outside the United States

FDDEI includes any deduction eligible income that is derived in connection with services provided by the taxpayer, which the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or for property, not located in the United States. Section 250 does not specifically define "United States." Both the Proposed and Final Regulations clarify that the term "United States" has the meaning set forth in section 7701(a)(9), as expanded by section 638(1) for mines, oil and gas wells, and other natural deposits.

The FDDEI Services rules do not require that the service recipient is a foreign person. Instead, the FDDEI Services rules require that the services are provided to any person, or for property, located outside the United States. Thus, domestic corporations can derive FDDEI from services provided to a U.S. person in certain circumstances.

Seven Categories

The Proposed Regulations divided all types of services into five exclusive categories: (1) general services to consumers, (2) general services to business recipients, (3) proximate services, (4) property services, and (5) transportation services. The Final Regulations maintain the same division of categories but add special rules for two subcategories of general services: (1) electronically supplied services, and (2) advertising services.

General Services Provided to Consumers

The Final Regulations retain the definition of a "general service" as any service that is not a property service, proximate service, or transportation service. The Proposed Regulations divided general services into two categories: (1) general services provided to consumers, and (2) general services provided to business recipients. The Final Regulations maintain this subdivision, but add the two new subcategories noted above: (1) electronically supplied services, and (2) advertising services.

For these purposes, a "consumer" is a service recipient that purchases a general service for personal use. Under both the Proposed Regulations and the Final Regulations, a general service is provided to consumers located outside the United States if the consumer resides outside the United States when the service is provided. The Final Regulations also provide that if the renderer does not have (or cannot after reasonable efforts to obtain) the consumer's location of residence when the service is provided, the consumer of a general service is treated as residing outside the United States if the consumer's billing address is outside the United States. This rule only applies subject to the "know or reason to know" standard. A renderer knows or 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 the consumer resides outside the United States.

For electronically supplied services that are provided to consumers, the Final Regulations provide that the consumer is deemed to reside at the location of the device used to receive the service. The location may be determined based on the device's IP address, if available. If the renderer cannot determine the location of that device after reasonable efforts, the general rule based on billing address applies, subject to the know or reason to know standard.

General Services Provided to Business Recipients

A "business recipient" is a service recipient other than a consumer, including all related parties of the recipient. However, if the service recipient is a related party of the taxpayer, the term "business recipient" does not include the taxpayer. A general service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on the business recipient's operations outside the United States. For purposes of determining the location of the business recipient's operations that benefit from a general service, the location of residence, incorporation, or formation of the business recipient is not relevant. A business recipient has operations where it maintains an office or other fixed place of business. If the business recipient does not have an identifiable office or fixed place of business, it is deemed to be located at its primary billing address. In response to taxpayer comments, the Final Regulations explicitly state that the location of residence, incorporation, or formation of the business recipient is not relevant to determining the location of the business recipient's operations that benefit from a general service.

The Final Regulations continue to provide that the determination of which operations of the business recipient benefit from a general service is made under the principles of Treas. Reg. § 1.482-9. The Final Regulations also clarify that in applying these principles, (1) the taxpayer, (2) the portions of the business recipient's operations within the United States (if any) that may benefit from the general service, and (3) the portions of the business recipient's operations outside the United States that may benefit from the general service, are treated as if they are each one or more controlled taxpayers.

"Benefit" is defined for these purposes as having the same meaning set forth in Treas. Reg. § 1.482-9(l)(3), which specifies how to identify directly resulting benefits and distinguishes them from indirect or remote benefits arising from a service. The Preamble noted that, in response to taxpayer comments, the use of this provision does not signal Treasury's or the IRS's intent to require taxpayers to perform a transfer pricing analysis of the recipient's operations. Rather, the reference is intended to clarify, using a concept that is based on existing tax principles, that a service confers a benefit on operations of a recipient only if an uncontrolled party with similar operations would pay for the service under comparable circumstances. The Final Regulations also note that the determination of benefit under the principles of Treas. Reg. § 1.482-9 is done by treating the taxpayer as one controlled taxpayer, treating the portions of the business recipient's operations outside the United States that may benefit from the service as one or more controlled taxpayers, and by treating the portions of the same inside the United States that may benefit from the service as one or more controlled taxpayers.

The amount of the benefit conferred on a business recipient's operations located outside the United States is determined under any method that is reasonable under the circumstances including (but not limited to) allocations based on the renderer's time spent or costs incurred or the business recipient's gross receipts, revenue, profits, or assets. The principles of Treas. Reg. § 1.482-9(k) apply to determine whether a method is reasonable, but are modified for purposes of section 250 to treat as "recipients" the business recipient's operations in different locations, and to treat as "costs" the renderer's gross income. Reasonable methods may include allocations based on time spent or costs incurred by the renderer or sales, profits, or assets of the business recipient.

Acknowledging that taxpayers generally may or will not have complete information regarding the operations of the business recipient, the Final Regulations provide taxpayers with flexibility to determine the extent to which a business recipient's operations within or outside the United States are treated as one or more separate controlled taxpayers for purposes of applying the principles of Treas. Reg. § 1.482-9. Taxpayers may use any reasonable method to determine the set and scope of business recipient operations that are treated as separate controlled taxpayers. For example, taxpayers can segregate the operations on a per entity or per country basis, or can aggregate all of the business recipient's operations outside the United States as one controlled taxpayer.

Treasury Regulations section 1.250(b)-5(e)(5)(ii)(A) and (B) ("Examples 1 and 2") provide helpful context for how these rules are intended to operate. In Example 1, a domestic corporation ("DC") provides a consulting service to an unrelated party ("R") that operates restaurants within and outside the United States in exchange for $150x. Fifty percent of R and its related parties' sales are to customers located outside the United States, but the consulting service that DC provides relates specifically to a single chain of fast food restaurants that R operates. Sales information that R provides to DC indicates that 70 percent of the sales of the fast food restaurant chain are from locations within the United States and 30 percent of the sales are from Country X. The facts further provide that DC determines that the use of sales is a reasonable method under the principles of Treas. Reg. § 1.482-9(k) to allocate the benefit of the consulting service among R's fast food operations.

Under Treas. Reg. § 1.250(b)-5(e)(2)(i), DC, R's fast food operations within the United States, and R's fast food operations in Country X, are treated as if they were controlled taxpayers because only these operations benefit from DC's service. By applying the principles of Treas. Reg. § 1.482-9(k) to determine the amount of DC's service that benefits R's operations outside the United States, 30 percent of DC's provision of the consulting service is treated as the provision of a service to a person located outside the United States and a FDDEI Service. DC's gross income ($150X) is allocated based on the sales of the fast food chain restaurants that benefit from DC's service. Accordingly, $45x ($150x times 0.30) of DC's gross income from the provision of the consulting service is included in DC's gross FDDEI for the taxable year.

The facts are the same in Example 2 except that DC provides an information technology service to R that benefits R's entire business, i.e., 50 percent of the sales earned by R and its related parties are from customers located outside of the United States. In this case, DC, R's operations within the United States, and R's operations in Country X, are treated as if they were controlled taxpayers because the service that DC provides relates to R's entire business. Fifty percent of the information technology service DC provides is treated as a service to a person located outside the United States and a FDDEI Service. Accordingly, 75x ($150x times 0.50) of DC's gross income from the service it provides is included in DC's gross FDDEI for the taxable year.

<u>Subcategories of General Services: Electronically Supplied Services and Advertising Services</u>

Electronically Supplied Services

An "electronically supplied service" is a general service, other than an advertising service, that is delivered primarily over the internet or an electronic network. This includes access to streaming content and other digitized products; on-demand access to certain computing hardware, software, and infrastructure; website or other network support; services automatically generated from a computer in response to data input; provision of information electronically; and similar services.

Observation: Proposed Treasury Regulations section 1.861-19, by its terms, applies to specified sections of the Code, including section 250. The Final Regulations' definition of "electronically supplied services" is the same, in practical effect, as the definition of "cloud transactions" in Prop. Treas. Reg. § 1.861-19.

The Final Regulations determine the location of consumers and businesses receiving electronically supplied services somewhat differently. A consumer receiving an electronically supplied service is deemed to be located where the device used to receive the service is located. If the renderer cannot with reasonable effort obtain the consumer's device location, then the location of the device is determined based on the billing address for the consumer unless the renderer has reason to know the consumer resides elsewhere based on information received as part of the provision of the service.

For a business recipient, an electronically supplied service generally is deemed received where the service is accessed by the recipient's employees, contractors, or agents. The operations of the business recipient that benefit from the service are deemed to be located at the recipient's billing address if the location where the service is accessed cannot be determined and the gross receipts from all services for the business recipient are in the aggregate less than $50,000 for the renderer's taxable year. Otherwise, the Final Regulations assume the operations of the business recipient that benefit are located in the United States. If a general service is only partially electronically supplied (e.g., a service performed partially online and partially by mail or in person), these rules apply where the primary purpose is to provide electronically supplied services.

Advertising Services

An "advertising service" is defined as a general service that consists primarily of transmitting or displaying content (including via the internet) to consumers with a purpose to generate revenue based on the promotion of a product or service.

For advertising services provided to business recipients, the operations of a business recipient that benefit from those services are located where the advertisements are viewed by individuals. If the advertisements are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. For this purpose, taxpayers may use the IP address to establish the location of a device on which the advertisement is viewed.

The Preamble notes that Treasury and the IRS determined that the location where the advertisement is viewed is a reliable proxy for the locations of the business recipient that benefits from the service because it is in the business recipient's best interest to advertise its products or services in the locations where it does business. Moreover, the Preamble explains that Treasury and the IRS believe that taxpayers typically know where advertising services are viewed.

Proximate Services

The Proposed Regulations defined a "proximate service" as a "service, other than a property service or a transportation service, provided to a recipient, but only if substantially all of the service is performed in the physical presence of the recipient or, in the case of a business recipient, its employees." The Final Regulations expand the definition of a proximate service to include services performed in the physical presence of other persons working for the recipient, such as employees, contractors, or agents. The "substantially all" standard is met for purposes of both the Proposed Regulations and the Final Regulations if the renderer is in the physical presence of the recipient (or other appropriate person) for more than 80 percent of the time during the provision of the service.

A proximate service gives rise to FDDEI based on where the service is performed. The Final Regulations specifically provide that a proximate service is provided to a recipient located outside the United States if the proximate service is performed outside the United States. If the proximate service is performed partly within the United States and partly outside of the United States, partial FDDEI treatment is permitted for the amount of income that corresponds to the portion of the proximate service that the renderer performs outside the United States. A proximate service can generate FDDEI even if a greater portion of the proximate service is performed in the United States.

<u>Property Services</u>

The Final Regulations provide that, unless the exception described below applies, property services qualify as FDDEI Services only if the service is provided for tangible property that is located outside the United States for the duration of the period that the service is performed. In addition, the Final Regulations clarify that manufacturing services are property services (and not general services) and, in limited circumstances, property services performed in the United States may qualify as FDDEI Services.

In response to a request in the Proposed Regulations, Treasury and the IRS received several comments stating that it would be appropriate to provide an exception and treat a property service as a FDDEI Service even if the property was temporarily located in the United States during the provision of the service. Under the Final Regulations, property services provided for property temporarily located in the United States will be deemed to be provided for tangible property located outside the United States if the following conditions are satisfied:

1. the property is temporarily located in the United States solely for the purpose of receiving the property service,
2. after the service is completed, the property will be primarily handled, stored, or used outside the United States,
3. the property is not used to generate revenue in the United States at any time during the duration of the service, and
4. the property is owned by a foreign person that resides or primarily operates outside the United States.

Treasury and the IRS did not provide a preview of these four conditions in the Proposed Regulations, nor was there a consensus in the comments about what conditions might be appropriate for property services to qualify for an exception for property located temporarily in the United States.

In addition, Treasury and the Service also clarified that manufacturing services are considered property services under the Final Regulations. Thus, Treasury and the

IRS take the position that treating manufacturing services as property services, potentially eligible for the exception for property temporarily located in the United States, addresses the concerns of several commenters that arrangements such as toll manufacturing services may not give rise to FDDEI.

Transportation Services

The Final Regulations maintain the definition of "transportation services" from the Proposed Regulations--a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any other mode of transportation. The Final Regulations clarify that freight forwarding and similar services are transportation services.

In addition, the Final Regulations maintain the rule from the Proposed Regulations--a transportation service is provided for property or to a recipient where both the service's origin and destination are outside the United States. Where either the origin or the destination (but not both) are outside the United States, then 50% of the gross income from the transportation service is treated as derived from a service provided for property or to a recipient outside the United States. Commenters requested several alternative approaches to the 50% rule where either the origin or the destination are outside the United States, but Treasury and the IRS determined that the 50% rule was simpler and more administrable.

Documentation Rules for FDDEI Services

To determine that a consumer or business recipient is located outside the United States, the Proposed Regulations required taxpayers to obtain specific types of documents (e.g., a written statement by the consumer indicating that they reside outside the United States when the service is provided, for consumers, or a binding contract specifying the locations of the business recipient's operations that benefit from the service, for business recipients).

As noted above, the Final Regulations relax these requirements and provide that for consumers, the taxpayer is required only to satisfy the substantiation requirements in section 6001. For general services provided to a business recipient, the Final Regulations require specific additional information to substantiate that (or the extent to which) a service provided to a business recipient is provided to operations located outside the United States in addition to the general substantiation requirements under section 6001. In particular, foreign use can be substantiated using (1) credible evidence obtained or created in the ordinary course of business from the recipient establishing the extent to which the service provides a benefit to locations outside the United States, or (2) a written statement providing specific information that is corroborated by credible and sufficient evidence.

Select Issues

Predominant Character Rule

The Proposed Regulations contained a predominant character rule that provided that if a transaction includes both a sale component and a service component, the transaction is classified according to the overall predominant character of the transaction for purposes of determining whether the transaction is subject to the

FDDEI Sales or FDDEI Services rules. The Final Regulations retained the rule from the Proposed Regulations and expanded it to apply to transactions that include multiple elements of FDDEI Sales. Accordingly, a transaction that includes both a sale of general property and a sale of intangible property will be characterized as either a FDDEI Sale of general property or a FDDEI Sale of intangible property based on the predominant character of the transaction, considering all relevant facts and circumstances.

As articulated in the Final Regulations, the predominant character rule does not apply to determine the particular category into which the provision of a service falls for purposes of determining whether such service is a FDDEI Service. Rather, the Final Regulations provide specific rules relevant to particular services with multiple elements that determine the applicable standard (e.g., for a service that is partially an electronically supplied service and partially a general service that is not an electronically supplied service, the location of the business recipient is determined using the rule for electronically supplied services).

Foreign Branch Income

Section 250(b)(3) excludes foreign branch income (as defined in section 904(d)(2)(J)) from DEI. The Proposed Regulations include income from the sale of a foreign branch in foreign branch income, and could be interpreted more broadly to override the general principle of regarding disregarded transactions reflected on the books and records and re-characterizing branch income into income of the home office. Treasury and the IRS agreed that the definition of foreign branch income should be consistent within both section 250 and section 904. Accordingly, the Final Regulations remove this modification.

Observation: The Proposed Regulations' broad definition of foreign branch income under section 250 appeared to be inconsistent with the Code. Under the Code, foreign branch income is defined the same for purposes of sections 250 and 904 by cross-referencing the definition in section 250 to section 904.

The Final Regulations define "foreign branch income" by cross reference to Treas. Reg. § 1.904-4(f)(2) without modification and confirm that the sale of an interest in a disregarded entity is considered the sale of that entity's assets, and therefore the rules for FDDEI Sales apply to determine whether the sale of each asset qualifies as a FDDEI Sale. By adopting a consistent definition of foreign branch income for purposes of FDII and the foreign tax credit, the Final Regulations permit gain from such a sale of a disregarded entity to be included in DEI and FDDEI, if the other requirements for FDDEI treatment are met. This modification may permit taxpayers more flexibility in restructuring foreign branch operations.

Section 962 Election for Individuals

The Final Regulations retain the rule in the Proposed Regulations that allows taxpayers making section 962 elections to take into account the section 250 deduction for GILTI, including the section 78 gross-up portion. However, both sets of rules do not permit deductions for the FDII portion.

Observation: The Final Regulations clarify that foreign tax credits for GILTI inclusions are available to individuals making the section 962 election (subject to the limitations of section 904(c) and 904(d)(1)(A)).

The Preamble to the Final Regulations notes uncertainty regarding situations in which individuals may make a section 962 election on an amended return, and states that the Treasury and the IRS are considering issuing further guidance under section 962. Further, the Preamble provides that until further guidance is published on this issue, individuals are permitted to make a section 962 election on an amended return for the 2018 tax year and subsequent years, provided the interests of the government are not prejudiced by the delay. Non-corporate U.S. taxpayers with CFC structures should examine their U.S. federal income tax reporting to determine if a section 962 election might benefit them in prior years 2018 or 2019, or thereafter. This may be particularly useful for non-corporate taxpayers that are deemed to own interests in CFCs because of the repeal of section 958(b)(4).

Taxable Income Limitation

As with certain other provisions of the Code, the FDII deduction is subject to a taxable income limitation. Proposed Treasury Regulations section 1.250(a)-1(c)(4) and Example 2 in Prop. Treas. Reg. § 1.250(a)-1(f)(2) provided an ordering rule for sections 163(j), 172, and 250. Some comments on the Proposed Regulations noted the ordering rule appeared to be circular in certain circumstances. Other comments highlighted its complexity. Treasury and the IRS removed the ordering rule provisions in the Final Regulations. It will be the subject of a future regulatory package.

In response to the Proposed Regulations, taxpayers commented that pre-2018 net operating losses ("NOLs") should be disregarded when allocating and apportioning expenses to gross DEI and gross FDDEI. Treasury and the IRS adopted this comment and the Final Regulations exclude these additional loss items from section 250 expense allocations by providing that "for purposes of determining the deductions of a domestic corporation for a taxable year properly allocable to gross DEI and gross FDDEI, the deductions of the corporation for the taxable year are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250." Treasury and the IRS noted that this approach "is consistent with the premise that the section 250 deduction is calculated based on annual income and expenses." Because of this approach, some taxpayers will have fewer expenses being allocated against gross DEI and gross FDDEI.

While Treasury and the IRS are considering the most appropriate guidance, the Preamble to the Final Regulations recommends taxpayers use a reasonable approach to address the interaction of sections 163(j), 172, 250, and other Code sections that refer to taxable income, and requests comments in this regard. The Preamble to the Final Regulations suggests that the ordering rule contained in the Proposed Regulations or the use of simultaneous equations may be reasonable. The approach selected by a taxpayer must be applied consistently for all taxable years beginning on or after January 1, 2021.

Application to Partnerships

The Final Regulations retained the rule in the Proposed Regulations that domestic corporate partners in a partnership are permitted to include their share of the partnership's items of gross DEI, gross FDDEI, and related deductions for purposes of calculating their FDII amount. Thus, an aggregate approach is applied for purposes of determining partner-level deductions.

Conversely, for purposes of determining whether a sale or service is a FDDEI transaction, Treasury and the IRS require the application of the entity approach. Commenters recommended treating a sale to a partnership as a FDDEI Sale: (i) to the extent the partnership predominantly engages in a foreign business, or (ii) to the extent of its ownership by direct and indirect foreign partners. Treasury and the Service did not adopt these comments noting that "the statute is clear that in the case of sales of property, the sale must be to a person that is not a United States person, and a domestic partnership is a United States person." In addition, determining the ownership of a partnership could present significant administrative difficulties.

The Final Regulations provide that a sale of a partnership interest cannot be a FDDEI Sale because a partnership interest is not general property. By contrast, the Proposed Regulations did not address the treatment of a sale of a partnership interest. The Preamble discusses this rule and states that Treasury and the IRS considered adopting a "look-through" approach to partnership interests but rejected such an approach because a partnership interest is "not the type of property" that can be subject to foreign use.

Foreign Military Sales

Foreign Military Sales ("FMS") are sales of property or the provision of a service to the U.S. government or an instrumentality thereof for resale or on-service to a foreign government or its instrumentality or agency. FMS are governed by the Arms Export Control Act of 1976, and participation in the program is limited to certain allies of the United States. The FMS program is highly regulated by the State Department and the Department of Defense.

> **Observation: As enacted as part of the Tax Cuts and Jobs Act, the FDII regime did not address foreign military sales. The Joint Committee on Taxation, in its 2018 Bluebook, provided that income from certain foreign military sales may be treated as foreign-derived deduction eligible income if the other requirements are met.**

The Proposed Regulations required FMS to be "on commercial terms" and required that the contract between the seller and the U.S. government specifically refer to the re-sale or on-service to a foreign government. These requirements were eliminated in the Final Regulations in response to comments that noted that "on commercial terms" is an ambiguous requirement that is not necessarily relevant in the context of military sales to U.S. allies. In addition, commenters noted that contracts subject to the Arms Export Control Act between sellers and the U.S. government may not specifically refer to re-sales or on-service to foreign governments, but that other documents prepared as part of the sale may provide evidence of foreign use. These other documents include State Department and Department of Defense forms that may be revised from time to time.

As a result, the Final Regulations provide that the sale of property or the provision of a service pursuant to the Arms Export Control Act is treated as a FDDEI Sale or Service, and the general rules in Treas. Reg. §§1.250(b)-4 and 1.250(b)-5 do not apply. No specific documentation requirements are imposed on FMS.

Waiving FDII Deduction

The Final Regulations do not provide guidance on whether a taxpayer may choose not to claim a FDII deduction. Rather, the Preamble notes that "[w]hether an allowable deduction must be claimed is governed by general tax principles and rules on whether such deduction can be elective is beyond the scope of these regulations."

> **Observation: Treasury has issued Final Regulations permitting taxpayers to waive an allowable deduction for purposes of the Base Erosion and Anti-abuse Tax (BEAT).**

Consolidated Groups

The Proposed Regulations provided for the computation of the FDII deduction on an aggregate, group-wide basis, with rules allocating the deduction among group members based on the relative contribution to group FDDEI. The Proposed Regulations also included a special rule providing that basis adjustments attributable to intercompany transactions are disregarded in determining QBAI. The Final Regulations generally maintain the Proposed Regulations' approach to applying section 250 to consolidated groups, except that they modify the rule that excludes intercompany transactions in calculating QBAI to provide that the rule applies only while the intercompany gain or loss is deferred.

Applicability Date

The Final Regulations are applicable for tax years beginning on or after January 1, 2021. A taxpayer may choose to apply the Final Regulations in their entirety for taxable years beginning before January 1, 2021, with the exception of the special substantiation requirements in Treas. Reg. § 1.250(b)-3(f) and the applicable provisions in Treas. Reg. § 1.250(b)-4(d)(3) or § 1.250(b)-5(e)(4)). Alternatively, a taxpayer may rely on Proposed Regulations in §§ 1.250(a)-1 through 1.250(b)-6 in their entirety for taxable years beginning before January 1, 2021. Taxpayers that choose to rely on the Proposed Regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 instead of only for taxable years beginning on or before March 4, 2019.

Potential APA Violations

Several provisions in the Final Regulations have no antecedent in the Proposed Regulations, which deprived regulated parties of notice of the rules and prevented regulated parties from providing comments on those rules. The provisions that appeared for the first time in the Final Regulations may violate the "logical outgrowth" rule under the Administrative Procedure Act ("APA"). A fundamental principle of informal rulemaking is that an agency's final rule must be a logical outgrowth of the agency's proposed rule. This principle is often referred to as the "logical outgrowth doctrine."

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First, the Final Regulations create a new category of services—"electronically supplied services"—and impose new rules for those services to qualify as FDDEI Services. The Final Regulations state that the consumer of an electronically supplied service is deemed to reside at the location of the device used to receive the service, which may be determined based on the location of the IP address when the service is provided. If the renderer does not have or cannot after reasonable efforts obtain the consumer's device location, the location of the device is determined based on the renderer's billing address for the consumer, unless the renderer has knowledge or reason to know otherwise. The Final Regulations also create a new subcategory of general services for "advertising services" and impose new rules for those services to qualify as FDDEI Services, as discussed above. The Proposed Regulations did not indicate Treasury's intent to add new categories of FDDEI Services or impose new requirements that taxpayers must satisfy to obtain FDII deductions for those categories. Thus, the Proposed Regulations did not "adequately foreshadow" these new rules, and the Final Regulations are not a "logical outgrowth" of the Proposed Regulations.

Second, the Final Regulations no longer define "foreign use" by reference to the lack of "domestic use." Instead, they provide that the "foreign use" requirement is met if a FDDEI Sale falls within one of six new categories. However, to ensure that a sale of property for manufacturing within the United States does not qualify as a FDDEI Sale, the Final Regulations include a new rule that provides that a sale of general property for manufacturing, assembly, or other processing in the United States is not for a foreign use even if the foreign use requirement would otherwise be satisfied. In effect, the Final Regulations disassociate "foreign use" and "domestic use" from each other, except to the extent that a domestic use of sold general property exists, in which case the foreign use requirement is deemed not satisfied. This is a significant departure from the approach in the Proposed Regulations.

The Proposed Regulations did not foreshadow these new rules, and Treasury and the IRS did not request comments on these provisions. In other circumstances, Treasury and the IRS solicited some comments in the Proposed Regulations (for example, asking for comments about whether property that is temporarily located in the United States for services should be eligible for FDII), but, in the Final Regulations, Treasury and the IRS wrote a rule that commenters did not ask for and that goes well beyond the scope of the comments that were requested in the Proposed Regulations (by providing four requirements that apply to property temporarily located in the United States, which taxpayers were not asked to comment on).

As a result of the changes described above and other changes not addressed herein, taxpayers may consider challenging the validity of the Final Regulations because Treasury and the IRS did not satisfy the APA's notice-and-comment rulemaking requirements. In lieu of a validity challenge, taxpayers could lobby Treasury and the IRS to withdraw the Final Regulations and issue new Proposed Regulations to cover the non-foreshadowed provisions. Alternatively, Treasury and the IRS could issue new guidance, in the form of a revenue ruling or other type of Internal Revenue Bulletin guidance, which covers the new provisions.

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What's Next?

The Final Regulations make several changes that will reduce taxpayer compliance burdens and provide greater certainty, though certain types of transactions are still subject to enhanced substantiation requirements. The transition rule should also be helpful for many taxpayers, providing additional time to refine compliance systems and procedures.

The Preamble to the Final Regulations mentions several other issues that may be the subject of future guidance and on which Treasury and the IRS seek comment, namely, the interaction of sections 163(j), 172, 250(a)(2), and other tax code sections that refer to taxable income, FDDEI Sales related to hedging transactions, and the treatment of life-nonlife consolidated groups.

Despite the many taxpayer-favorable provisions in the Final Regulations, U.S. trading partners have suggested that the FDII rules may run afoul of international standards. Today, the FDII rules are under review by the Organisation for Economic Co-operation and Development ("OECD") as a potential harmful preferential regime, and the European Union ("EU") has suggested that the FDII rules may violate international trade law. Although some EU member countries have publicly stated that they are considering challenging FDII at the World Trade Organization ("WTO"), it is unclear whether the changes in the Final Regulations will make it more or less likely for a WTO challenge to be filed and, if filed, succeed.