FIRST CUP OF COFFEE – TAX REFORM:
PART III (FDII)

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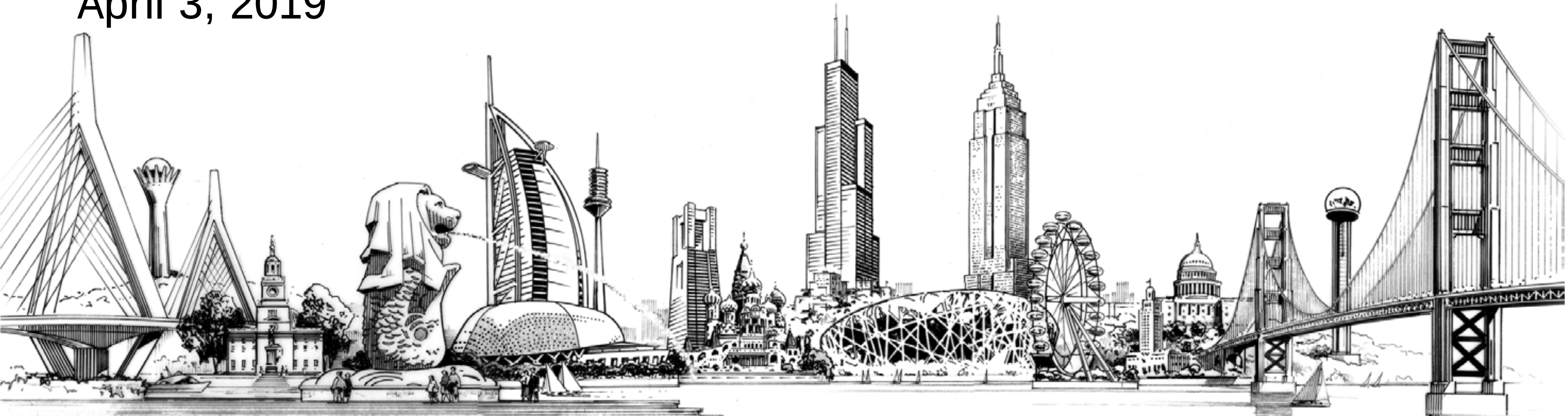


Overview

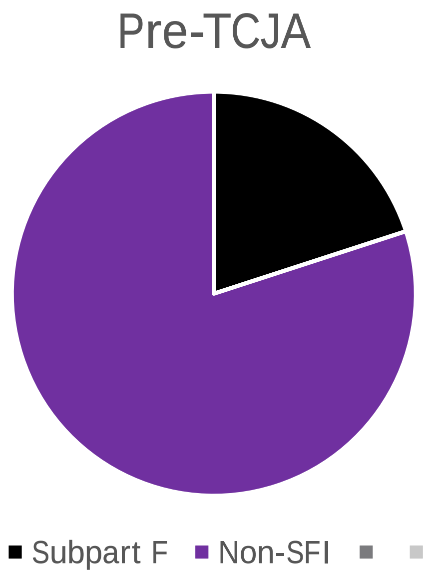
- Recap of GILTI provisions
- Overview of FDII provisions
- FDII Proposed Regulations
  - Sec. 250 calculations
  - Qualified business asset investment (QBAI)
  - FDDEI Transactions (generally)
  - FDDEI Sales
  - FDDEI Services
  - Related-Party Transactions

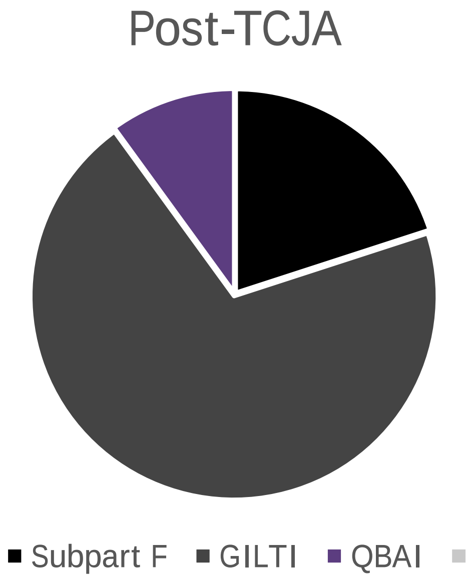
GILTI – OVERVIEW AND RECAP

Recap of GILTI

- U.S. Shareholder of CFC must recognize pro rata share of GILTI
  - Taxed at 10.5%
  - Foreign tax credit limitation
- GILTI – In broad strokes
  - Foreign income previously eligible for deferral (non-subpart F or effectively connected income), *less*
  - A routine return on tangible, depreciable assets used to generate income (10% of the basis)
- The FDII rules target (roughly) the same bucket of foreign earnings

TCJA – GILTI





FDII – OVERVIEW

Foreign Derived Intangible Income (FDII)

- Companion provision to GILTI rules
- FDII earned by a U.S. corporation taxed at 13.125%
  - Rate achieved through 37.5% deduction for FDII
  - FDII and GILTI (collectively) may not exceed taxable income (“§ 250(a)(2) limitation”)
    - Any excess over taxable income results in proportionate reduction of FDII and GILTI
- Special Rules
  - “Sale” defined broadly to include licenses and leases
  - Sales to domestic parties – domestic use, even if domestic purchaser produces goods ultimately sold to foreign persons and destined for foreign use
  - Sales to foreign related parties – foreign use if foreign related purchaser sells to foreign persons for foreign use

Foreign Derived Intangible Income (FDII)

- **FDII = DII x [FDDEI / DEI]**
  - DII – Deemed Intangible Income
  - DEI – Deduction Eligible Income
  - FDDEI – Foreign Derived Deduction Eligible Income
- **DII = DEI – DTIR**
  - DTIR = Deemed Tangible Income Return
- **DEI = Gross income* - allocable deductions**
  - * Gross income determined without regard to (i) Subpart F income, (ii) GILTI, (iii) financial services income, (iv) dividends from CFCs, (v) domestic oil and gas extraction income, and (vi) foreign branch income
  - Expenses allocation - §§ 1.861-8 through -14T, and -17
  - COGS may be allocated under any reasonable method

Foreign Derived Intangible Income (FDII)

- FDDEI– DEI derived
  - Property – sold to a non-U.S. person for foreign use
    - “Sales” include licenses and leases
  - Services – provided to persons or with respect to property located outside the U.S.
- DTIR = 10% x QBAI
  - QBAI – Qualified Business Asset Income
- QBAI = tangible, depreciable property used to generate DEI

FDII Proposed Regulations

- 1.250(a)-1 – Deduction for FDII and GILTI
- 1.250(b)-1 – Computation of FDII
- 1.250(b)-2 – QBAI
- 1.250(b)-3 – FDDEI Transactions
- 1.250(b)-4 – FDDEI Sales
- 1.250(b)-5 – FDDEI Services
- 1.250(b)-6 – Related Party Transactions

SECTION 250 CALCULATIONS

Sec. 250 Calculations

- **Step 1 – Tentative § 250 Deduction**
  - Hypothetical § 250 deduction used to calculate § 163(j) and NOL limitations
  - TI does not take into account § 163(j), NOL, or § 250 deduction
- **Step 2 - § 163(j) calculation**
  - Interest deduction limited to 30% of adjusted taxable income (ATI)
  - ATI takes into account Tentative § 250 Deduction; NOL not taken into account
- **Step 3 – NOL limitation**
  - NOL limited to 80% of taxable income (TI)
  - TI takes into account interest allowed under § 163(j); Tentative § 250 Deduction not taken into account

Sec. 250 Calculations

- **Step 4 – Calculate FDII**
  – DEI takes into account interest allowed under § 163(j) and allowable NOL
- **Step 5 – Calculate FDII deduction**
  – 37.5% of FDII
  – Reduce to the extent of § 250(a)(2) limitation

Foreign Derived Intangible Income – Example of Ordering Rules

DC is a domestic corporation and is not a member of a consolidated group:

NOL Carryover = $130 (100% allocable to Gross FDDEI)

Business Interest = $100 (100% allocable to Gross FDDEI)

Gross DEI = Gross FDDEI = $300 (*i.e.*, Foreign Ratio of 1)

QBAI = $0

1. **Tentative Section 250 Deduction** – ignore the section 163(j) business interest limitation and the NOL carryover in section 172(b):

<u>Tentative 250 Deduction = $75</u> = $200 (FDII) *multiplied by* 37.5%

– DEI = $200 = $300 Gross DEI *minus* $100 business interest

– FDDEI = $200 = $300 Gross FDDEI *minus* $100 business interest

– DII = $200 = $200 (DEI) *minus* $0 (QBAI x 10%)

– FDII = $200 *multiplied by* ($200 (FDDEI) / $200 (DEI))

Foreign Derived Intangible Income – Example of Ordering Rules (continued)

2. **Business Interest Deduction** –ignore the NOL carryforward but consider the Tentative Section 250 Deduction:

   Allowable Business Interest = $67.50 = $225 *multiplied by* 30% limitation; $32.50 of business interest disallowed

   – Taxable Income = $225 = $300 *minus* $75 (Tentative Section 250 Deduction)

   Taxable Income is calculated *without* regard to DC's section 163(j) interest or *any* NOL under section 172.

3. **NOL Deduction** – ignore the Tentative Section 250 Deduction but consider the 163(j) business interest limitation:

   NOL Deduction = $130 because ≤ $186 limitation

   – Taxable Income = $232.50 = $300 *minus* $67.50 (business interest)

   – NOL Limitation = $186 = $232.50 *multiplied by* 80% NOL limitation

4. **FDII Amount** – consider both the section 163(j) business interest limitation and the NOL limitation but ignore the Tentative Section 250 Deduction:

   FDII = $102.50 = $102.50 (DII) *multiplied by* ($102.50 (FDDEI) / $102.50 (DEI))

   – DEI = $102.50 = $300 (Gross DEI) *minus* $67.50 (permitted interest) *minus* $130 (permitted NOL)

   – FDDEI = $102.50

   – DII = $102.50 (DEI) *minus* $0 (QBAI x 10%)

Foreign Derived Intangible Income – Example of Ordering Rules (continued)

5. **Section 250 Deduction** – consider both the 163(j) business interest limitation and the NOL limitation but ignore the Tentative Section 250 Deduction:

Section 250 Deduction = $38.44 = $102.50 (FDII) *multiplied by* 37.5% deduction

– Taxable Income = $102.50 = $300 Gross Income *minus* $197.50 (permitted business interest + permitted NOL)

– $102.50 (FDII) $\leq$ $102.50 (Taxable Income) => No Reduction to FDII Amount

Sec. 250 Calculations

Taxable Income calculated with regard to:	Tent. § 250 Ded.	§ 163(j) Lim.	NOL
Step 1 – Tentative § 250 Deduction	-	NO	NO
Step 2 – Section 163(j) limitation (30% ATI)	YES	-	NO
Step 3 – NOL limitation (80% TI)	NO	YES	-
Step 4 – FDII (DEI)	NO	YES	YES
Step 5 - § 250 Deduction / § 250(a)(2)	-	YES	YES

QUALIFIED BUSINESS ASSET INVESTMENT (QBAI)

Qualified Business Asset Investment

- QBAI - In general
  - Tangible, depreciable property used to generate DEI
  - Average adjusted basis of property determined at the end of each quarter
  - Depreciated under § 168(g) alternative depreciation system (ADS)
    - Existing property treated as if depreciated under ADS from time of acquisition
  - Dual-use property – basis must be allocated between QBAI and non-QBAI
    - Directly identifiable income – allocate based on DEI / income from property
    - Not directly identifiable income – allocate based on DEI / income of owner
  - Roughly same rules and principles used under GILTI rules

Qualified Business Asset Investment

- QBAI – held through partnerships
  - Tangible, depreciable property used to generate DEI of partnership
  - Average adjusted basis of property determined at the end of each partnership quarter
    - Partner share based on distributive share
    - Base determined at the end of partnership year ending within partner year
  - Dual-use property – basis must be allocated between QBAI and non-QBAI
    - Directly identifiable income – allocate based on DEI / income from property
    - Not directly identifiable income – allocate based on DEI / income of partnership

Qualified Business Asset Investment

- Anti-abuse rule – Transfer of property disregarded if:
  - Transferred to a specified related party (50%-related)
  - During the disqualified period
    - Beginning 1 year prior to transfer, and
    - Ending earlier of (i) end of recovery period or (ii) 1 year after transfer
  - Lease back (or lease to a FDII-eligible 80%-related corporation or partnership)
  - With a principal purpose of reducing DTIR
    - *Per se* rule deems principal purpose if sale and lease occur within 6 months

Qualified Business Asset Investment

- Anti-abuse rule – Structured transactions – unrelated lessor treated as a specified related party if:
  - Reduction in DTIR is a material factor in pricing of the lease
  - Based on all facts and circumstances, reduction of DTIR was a principal purpose of arrangement
    - Marketed as “tax-advantaged”
    - Primarily marketed to domestic corporations earning FDDEI
    - Terms of arrangement allow for change if DTIR becomes no longer relevant
    - Below market return in the absence of tax effects

FDII TRANSACTIONS

FDDEI Transactions

- General Rules
  - Identify transaction as either (i) a sale or (ii) a service
  - Mixed transactions characterized based on “predominant character”
- General documentation requirements
  - Do not know or have reason to know documentation unreliable / inaccurate
  - Obtained before Filing Date (due date for U.S. tax return, with extensions)
  - Obtained no earlier than one year before sale or provision of services
- Special rules
  - Foreign government sales – sales through U.S. government considered direct sales to foreign government
  - Losses – Cannot intentionally “flunk” documentation requirements to increase FDDEI

FDII SALES

FDDEI Sales – In general

- Two principal categories
  - General property
  - Intangible property

- General requirements
  1. Sale to a foreign person
  2. Foreign use

FDDEI Sales – General and Intangible Property

- Sale to a foreign person
  - Documentation requirement – may be satisfied through:
    - Written statement
    - In the case of entities, organizational documents
    - In the case of individuals, valid government identification
    - Government filings (e.g., SEC reporting)
  - Do not know or have reason to know recipient is not a foreign person

FDDEI Sales – General Property

- Property is sold for <u>foreign use</u>
  1. Do not know or have reason to know that property is not for foreign use
  2. Documentation requirement
     - Written statement – establishing foreign use
     - Binding contract – requiring foreign use
     - Shipping documentation (e.g., export bill)

  - Special rules
     - Small business / transaction exception – shipping address may be used if:
        - Seller gross receipts < $10M
        - Sales to recipient < $5K
     - Fungible goods / mass – may rely on market research, statistical sampling, etc.

FDDEI Sales – General Property

- Property is sold for foreign use (cont.)
  - Evidence of foreign use
    1. Not subject to domestic use within 3 years of delivery, or
    2. Subject to manufacture, assembly, or processing before domestic use
       - Physically and materially changed (facts / circumstances)
       - Incorporated as a component into a second product
         - FMV of component < 20% of FMV of second product
         - Components sold by same seller aggregated

FDDEI Sales – General Property

- Transportation property
  - Vehicles or other transportation property capable of traveling internationally
  - Considered foreign use if:
    - Located outside of the U.S. > 50% of time
    - Miles traveled outside U.S. > 50% of time
  - Per se rules
    - All use considered foreign if > 90% use outside U.S.
    - All use considered domestic if < 10% of use outside U.S.

FDDEI Sales – Intangible Property

- Property sold for <u>foreign use</u>

1. Do not know or have reason to know that property is not for foreign use
2. Documentation requirement
   - Written statement – establishing foreign use
   - Binding contract – requiring foreign use
   - Audited financial statements – showing location where revenue generated
   - Statements / documentation used to determine / compute royalties or compensation
3. Evidence of foreign use
   - Revenue from sale / license generated outside of United States
   - Mixed use – foreign use determined based on percentage of revenue generated outside of U.S.
     - Reliance on projections and financial data permitted in some circumstances

FDII SERVICES

FDDEI Services – In general

- Five principal categories:
  - Proximate services
  - Property services
  - Transportation services
  - General services (residual) – to consumers
  - General services (residual) – to business recipients

- General requirements
  - Provision to a person or with respect to property located outside U.S.

FDDEI Services – Proximate, Property, Transportation

- Proximate Services
  - Substantially all of services performed in the physical presence of recipient outside U.S.
    - Meets threshold if > 80% of time spent in physical presence
  - If less the substantially all performed outside U.S., allocation based on time spent performing inside / outside U.S.
- Property Services
  - Property must be located outside U.S. for duration of services
- Transportation Services
  - Services involving vehicles or other transportation
  - FDDEI Service if departure and destination located outside U.S.
  - If either departure or destination in U.S., 50% of service treated as FDDEI Service

FDDEI Services – General - Consumers

- Requirements to establish foreign use:
  - Do not know or have reason to know recipient is not a foreign person
  - Documentation requirement – may be satisfied through:
    - Written statement
    - Valid government identification
  - Small business / transaction exception – shipping address sufficient

FDDEI Services – General – Business Recipients

- General Rule – Gross income allocable to operations of business recipient located outside of U.S. eligible for FDDEI treatment
  - Specifically identifiable operations
  - No specifically identifiable operations (or general benefit)
    - Allocation pro rata to all operations of business recipient
    - May use any reasonable methodology (see Treas. Reg. § 1.482-9(k)), including:
      - Time spent
      - Costs incurred
      - Gross receipts, revenue, profit, or assets of business recipient

FDDEI Services – General – Business Recipients

- <u>General Rule</u> – Gross income allocable to operations of business recipient located outside of U.S. eligible for FDDEI treatment
- Requirements to establish foreign use:
  - Do not know or have reason to know recipient is not a foreign person
  - Documentation requirement – may be satisfied through:
    - Written statement
    - Binding contract
    - Documents prepared in ordinary course of business
    - Publicly available information
  - Small business / transaction exception – shipping address sufficient

FDDEI Sales – Related Party Rules

- Related Party Sales – count as FDDEI Sales if either:
  1. Related buyer sells to foreign unrelated party (unrelated party transaction)
     - The unrelated party transaction would otherwise constitute an FDDEI sale / service
     - The unrelated party transaction occurs either:
       - Before the filing date, or
       - After the filing date, and an amended return is filed
  2. Property used in unrelated party transaction
     - Seller reasonably expects property will be used in unrelated party transaction
     - The unrelated party transaction would otherwise constitute an FDDEI sale / service
     - Revenue from unrelated party transaction > 80% of total revenue received by related buyer

FDDEI Services – Related Party Rules

- Related Party Services – count as FDDEI Services if:
  - Service is not substantially similar to service provided by related party to persons in U.S.
  - Considered substantially similar if:
    - 60% of benefit of related party service conveyed to persons in U.S.
    - 60% of price for unrelated party service paid by persons in U.S.
  - If substantially similar, gross income from FDDEI Services allocated based on benefits conferred to persons outside U.S. relative to total benefit

Biography

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Michael Liu advises multinational corporations with domestic and international tax planning. His clients span a variety of industries, including those in the high technology, semiconductor, software, pharmaceuticals, and biotechnology sectors. Before joining Morgan Lewis, he was a partner in the tax practice of another global law firm, based in Palo Alto. Michael is admitted in California only, and his practice is supervised by Illinois Bar members.

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Gregory Hartker focuses his practice on domestic and international corporate and partnership tax issues, as well as on investment fund structuring and representing investors in such funds. Gregory represents clients in both taxable and tax-deferred mergers and acquisitions, public and private issuances of debt instruments, and partnership and LLC structuring and operating issues. Additionally, his international tax background includes matters involving Subpart F, PFIC, foreign tax credits, withholding, treaty issues, cost sharing, and cross-border transfer pricing.

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Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
Orange County
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Philadelphia
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Princeton
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Shanghai*
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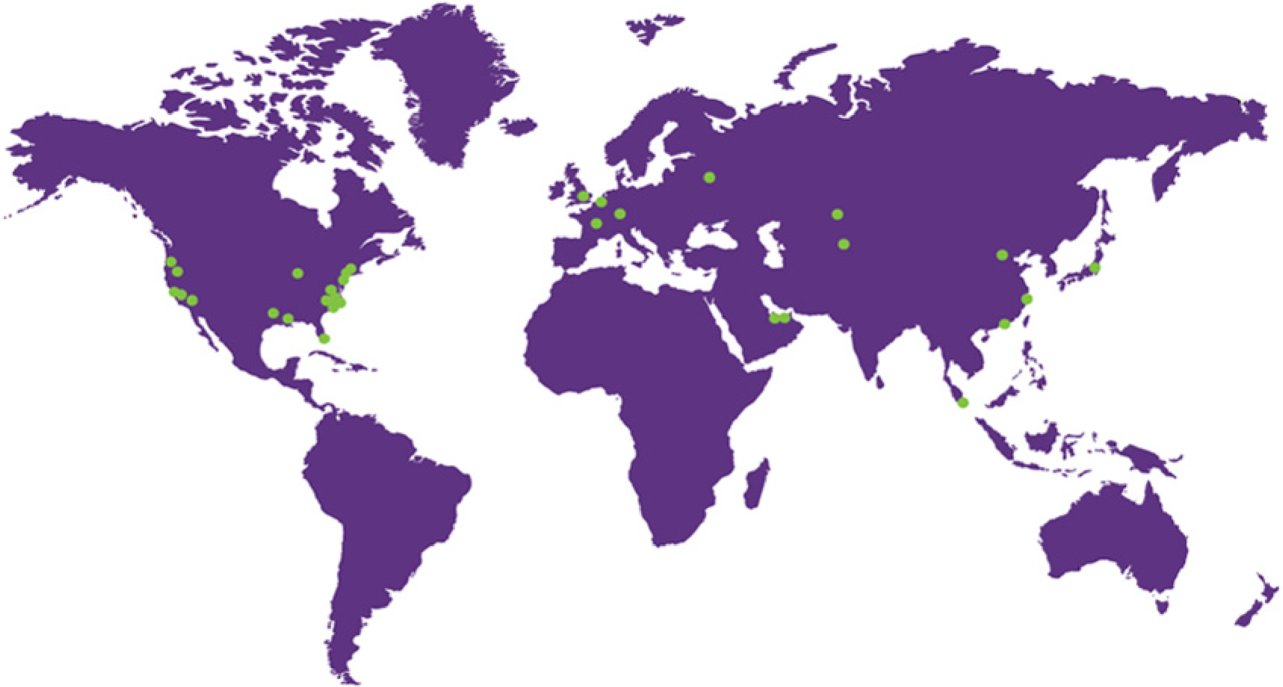

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