PROPOSED F.D.I.I. REGULATIONS: DEDUCTIONS, SALES, AND SERVICES

Authors
Fanny Karaman
Beate Erwin

Tags
F.D.I.I.
Tax Reform
T.C.J.A.

On December 22, 2017, the Tax Cuts and Jobs Act 2017 ("T.C.J.A.")[1] introduced the foreign derived intangible income ("F.D.I.I.") regime into the Code. This tax favorable regime is limited to entities taxed as U.S. corporations.

In essence, F.D.I.I. constitutes a taxable U.S. corporation's income from specified export activities. More precisely, the F.D.I.I. regime allows for a reduced corporate tax on hypothetical intangible income used in a U.S. business in exploiting foreign markets. Under the F.D.I.I. rules, the hypothetical intangible income is reduced by a 37.5% deduction, which is intended to result in an effective Federal corporate income tax rate of 13.125% for a U.S. corporation.[2] It is important to note that, due to the way F.D.I.I. is computed, the effective rate on export income is generally higher than 13.125% under this rule.

On March 6, the I.R.S. published comprehensive proposed regulations addressing F.D.I.I.[3] They contain a substantial number of examples. If adopted in final version, the proposed regulations would be applicable to taxable years ending on or after March 4, 2019.[4]

THE F.D.I.I. COMPUTATION – A BRIEF RECAP

To determine its F.D.I.I. deduction, a domestic corporation must first determine its F.D.I.I. amount.

This determination is made through a multistep process that involves the following calculations:

1. Deduction eligible income ("D.E.I.")
2. Foreign derived deduction eligible income ("F.D.D.E.I.")
3. Qualified business asset investment ("Q.B.A.I.")
4. Deemed intangible Income ("D.I.I.")[5]
5. F.D.I.I.

---

[1] Public Law 115-97.

[2] For tax years beginning after December 31, 2025, the allowable deduction is decreased, and the effective tax rate will be 16.406% (Code §250(a)(3)(A)).

[3] I.R.S.; Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income, 84 Fed. Reg. 8188 (March 6, 2019).

[4] Prop. Treas. Reg. §1.250-1(b).

[5] See in detail, "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?" *Insights* 5, no. 1 (2018), Components of the F.D.I.I. Provision.

The formula to determine F.D.I.I. can best be summarized by the following equations:

F.D.I.I. Equation
F.D.I.I. = D.I.I. * (F.D.D.E.I. / D.E.I.) [6]

D.I.I. Equation
D.I.I. = D.E.I. – (Q.B.A.I. * 10%)

A key concept under F.D.I.I. is the computation of a U.S. corporation's hypothetical intangible income, known as D.E.I. The computation of D.E.I. begins with the gross income of the domestic corporation, from which the following income items are removed:

- Subpart F Income derived from controlled foreign corporations ("C.F.C.'s") and included in taxable income under Code §951(a)(1)
- Amounts of global derived intangible income ("G.I.L.T.I.") derived from C.F.C.'s and included in taxable income under Code §951A
- Financial services income of the corporation – typically limited to financial institutions
- Any dividend received from a C.F.C.[7]
- Domestic oil and gas extraction income of the corporation
- Foreign branch income[8]

D.E.I. is then reduced by a deemed 10% return on the corporation's Q.B.A.I.[9] Q.B.A.I. is measured by reference to the U.S. corporation's average aggregate adjusted bases in depreciable tangible property used in the production of D.E.I. The result is then prorated in the ratio export-related D.E.I. (*i.e.*, F.D.D.E.I.) bears to total D.E.I.

For purposes of the computation, F.D.D.E.I. is D.E.I. derived in connection with (i) property sold to a non-U.S. person for non-U.S. use ("F.D.D.E.I. Sales") and (ii) services provided by the taxpayer to persons, or with respect to property, located outside the U.S. ("F.D.D.E.I. Services").[10] "Non-U.S. use" means use, consumption, or disposition that occurs outside the U.S.[11] The term "sold" includes any lease,

---

[6] The ratio F.D.D.E.I. to D.E.I. is also referred to as foreign derived ratio ("F.D.R.").

[7] Under the definition as expanded by the T.C.J.A., a non-U.S. corporation is a C.F.C. if more than 50% of the voting power or value of all shares outstanding are owned by one or more U.S. Shareholders. A U.S. person is a U.S. Shareholder if it owns at least 10% of the voting power or value of all outstanding shares of the foreign corporation.

[8] Code §250(b)(3)(A)(i)(VI).

[9] Code §250(b)(2)(A).

[10] Code §250(b)(4).

[11] Code §250(b)(5). Specific rules exist for non-U.S. related-party transactions.

license, exchange, or other disposition.[12] Specific rules exist (i) for property or services provided to a U.S. intermediary and (ii) with respect to related-party transactions.[13]

Finally, the F.D.I.I. deduction, increased by the G.I.L.T.I. and the related Code §78 gross-up deductions, is subject to a taxable income limitation.[14] If this aggregate amount exceeds the corporation's taxable income (determined without regard to these deductions), the excess reduces the G.I.L.T.I. and F.D.I.I. amounts *pro rata*.

"F.D.D.E.I. is D.E.I. derived in connection with (i) property sold to a non-U.S. person for non-U.S. use and (ii) services provided by the taxpayer to persons, or with respect to property, located outside the U.S."

WHO CAN BENEFIT FROM THE REGIME?

Domestic corporations and domestic corporate partners can benefit from the regime.

The proposed regulations clarify that for purposes of the F.D.I.I. regime, a domestic corporation is defined by reference to Code §7701(a).[15] Thus, it is available to associations, joint-stock companies, or insurance companies created or organized in the U.S. or under the law of the U.S. or of any state, with the exception of regulated investment companies, real estate investment trusts, or S-corporations. This implies that entities formed in the U.S., and that elect to be treated as corporations for U.S. tax purposes, are allowed the F.D.I.I. deduction if the requirements of the regime are otherwise met.

Further, a direct or indirect domestic corporate partner of a partnership takes into account its distributive share of the partnership's gross D.E.I., gross F.D.D.E.I., partnership deductions, and partnership Q.B.A.I.[16] Essentially, the F.D.I.I. computation is made at the corporate partner level on an aggregate basis and not at the partnership level. Since the Code §250 deduction is computed at the corporate partner level, it does not increase the corporate partner's outside basis in the partnership.[17]

HOW ARE DEDUCTIONS TAKEN INTO ACCOUNT?

Does the Taxable Income Limitation Take into Account Limitations Related to Interest Deductions and N.O.L. Deductions?

As explained earlier, the F.D.I.I., G.I.L.T.I., and related Code §78 gross-up deductions cannot exceed the taxpayer's taxable income. In other words, the taxpayer cannot benefit from a loss under these rules.

---

[12] Code §250(b)(E).

[13] Code §250(b)(5).

[14] "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?"

[15] Prop. Treas. Reg. §1.250(a)-1(c)(1).

[16] Prop. Treas. Reg. §§1.250(b)-1(e), 2(g). While Code §250(a)(1) allows a deduction to a domestic corporation, it does not provide rules for domestic corporations that are partners in a partnership. However, the preamble to the proposed regulations clarifies that the conference report accompanying the T.C.J.A. suggests that Congress intended that a domestic corporate partner of a partnership receive the benefit of a Code §250 deduction for its F.D.I.I. and G.I.L.T.I. (Preamble to the proposed regulations referencing H. Rept. 115-466, at 623, n. 1517 (2017)).

[17] Preamble to the Prop. Treas. Reg., Section 3, p. 16.

However, the very definition of "taxable income" is not provided for purposes of Code §250. Certainly, the concept of "taxable income" entails net basis taxation, *i.e.*, taking into account appropriate deductions. Further, several provisions, such as Code §§163(j), 172, and 250, contain a deduction limitation based, in one shape or another, on taxable income. The central question then becomes, "How do these various limitations apply and interrelate?"

The proposed regulations address this issue by clarifying the interaction between Code §§172, 163(j), and 250. More specifically, the proposed regulations provide an ordering rule for determining the taxable income or adjusted taxable income limitations applicable to each provision. They provide that the Code §172 limitation is determined without a taxpayer's Code §250 deduction, and a taxpayer's adjusted taxable income for the interest expense limitation of Code §163(j) is determined without the net operating loss ("N.O.L.") provisions of Code §172.

More specifically, the taxpayer must follow the following consecutive steps:

1. **Tentative §250 Deduction:** Consider all other deductions except for Code §§163(j) and 172, and the Code §250 taxable income limitation.

   A taxpayer computes a tentative Code §250 deduction and a tentative F.D.I.I. amount by taking into account all deductions with the exception of (i) interest expense carryforwards or disallowances under Code §163(j), N.O.L. deductions under Code §172(a), and (iii) the Code §250 taxable income limitation.

2. **Allowed Interest Deduction:** Consider tentative Code §250 deduction but not Code §172 deduction.

   The taxpayer computes its allowed interest deduction pursuant to Code §163(j), taking into account its tentative Code §250 deduction computed under Step 1 but not the N.O.L. deductions allowed under Code §172(a).

3. **N.O.L. Deduction:** Consider Code §§163(j) and 172 but not Code §250 actual and tentative deductions.

   The taxpayer determines its N.O.L. deduction, taking into account the allowed interest expense deduction under Code §163(j) and the taxable income limitation of Code §172(a)(2) but without regard to its tentative Code §250 deduction or its actual Code §250 deduction.

4. **F.D.I.I.:** Consider Code §163(j) and N.O.L. deduction.

   The taxpayer computes its F.D.I.I. after taking into account its allowable interest expense deduction under Code §163(j) (as determined under Step 2) and its N.O.L. deduction (as determined under Step 3).

5. **Code §250 Deduction:** Consider Code §§163(j) and 172, and the Code §250 taxable income limitation.

   The taxpayer computes its Code §250 deduction by taking into account its business interest deduction under Code §163(j), its N.O.L. deduction under Code §172(a), and its Code §250 taxable income limitation.

The proposed regulations include a comprehensive example that illustrates the operation of this rule and the interplay between the provisions of Code §§163(j) and

172(a).[18] Comments on the ordering rules are invited by the Treasury.

Are There Other Limitations Related to Allowable Deductions?

A domestic corporation could have a loss F.D.D.E.I. amount when costs associated to F.D.D.E.I. services or sales exceed the income therefrom. This, in turn, could decrease the domestic corporation's F.D.D.E.I. to D.E.I. ratio, thus decreasing the effective Code §250 deduction.

As explained below, domestic corporations wishing to benefit from the Code §250 deduction must generally comply with substantial documentation requirements in order to qualify for the deduction. However, when their ratio would be decreased because of loss F.D.D.E.I., the I.R.S. is warry that such taxpayers may intentionally fail to comply with the documentation requirements in order to exclude the loss F.D.D.E.I. altogether, thus avoiding a decrease in their F.D.I.I. deduction. As a result, and only in the context of loss F.D.D.E.I., the sale of property or the provision of a service will still be treated as F.D.D.E.I. if said treatment would result in the reduction of a corporation's F.D.D.E.I.

The effect of non-recognition of an F.D.D.E.I. loss on the F.D.I.I. deduction becomes apparent in the following example:

Example

Assume that after deduction of allocable cost of goods sold, U.S. corporation Y derives gross income or losses from F.D.I.I. eligible sales to foreign persons as follows:

- Product A: Loss of $50
- Product B: Gross income of $600
- Product C: Gross income of $550

D.E.I. amounts to $2,400, and D.I.I. is $100.

Taking into account the loss from the sale of Product A, the F.D.R. would amount to 47% (1150 divided by 2400). Hence, Y's F.D.I.I. would be $47 (100 * 47%); whereas, if Y excluded the loss, its F.D.I.I. would increase to $50 (100 * [1200/2400]). Accordingly, while generally losses cannot be incurred for purposes of F.D.I.I. determination, the F.D.D.E.I. loss must be taken into account by the taxpayer in order to avoid dilution of the F.D.R.[19]

IS THE DEDUCTION ALWAYS AVAILABLE WHEN A U.S. CORPORATION SELLS ON A FOREIGN MARKET?

An important aspect is the exclusion of foreign branch income from the definition of F.D.I.I. Thus, not all income generated from sales to a foreign market can benefit from the Code §250 F.D.I.I. deduction.

[18] Prop. Treas. Reg. §1.250(a)-1(f), ex. 2.

[19] See also the example under Prop. Treas. Reg. §1.250(b)-3(f)(2) (limited to the F.D.R. impact).

As explained earlier, F.D.I.I. does not include foreign branch income.[20] Foreign branch income is defined by reference to the foreign tax credit provision of Code §904(d)(2)(J) and to proposed foreign tax credit regulations of Prop. Treas. Reg. §1.904-4(f). Foreign branch income is defined as business profits, but not passive category income, of a U.S. person attributable to a qualified business unit ("Q.B.U.") in a foreign country. The notion of Q.B.U. comes from Subpart J of the Code dealing with foreign currency transactions. For foreign currency transaction purposes, a Q.B.U. is a separate and clearly identified unit of a trade or business of a taxpayer maintaining separate books and records.[21] Thus, a "foreign branch" is not necessarily the equivalent of a trade or business for foreign currency transaction purposes. However, the proposed foreign tax credit regulations under Prop. Treas. Reg. §1.904-4(f)(3), while defining a Q.B.U. by reference to the foreign currency transaction rules, add a requirement that the Q.B.U. conducts a trade or business outside the U.S. They also specify that a non-U.S. permanent establishment of a U.S. taxpayer under an applicable income tax treaty is presumed to constitute a qualifying non-U.S. trade or business.

"Income from servicing the foreign market may be excluded altogether from the definition of F.D.I.I. if the taxpayer directly or indirectly operates through a permanent establishment in the foreign country."

Notably, the proposed regulations under Code §250 go even further by including in foreign branch income (and thus excluding from F.D.I.I.) the income from the direct or indirect sale of any asset (other than stock) producing gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest.[22] This encompasses any sale, lease, license, exchange, or disposition of property, including property transfers in which gain or income is recognized under Code §367.[23] Under these rules, transfers of intangible property ("I.P."), as defined under Code §367(d)(4), between a foreign branch owner and a foreign branch are recharacterized. As a result, for F.D.I.I. purposes, it is not sufficient for a U.S. corporation to ultimately sell its property or services to a foreign market. Rather, it must be aware that its entire income from servicing the foreign market may be excluded altogether from the definition of F.D.I.I. if the taxpayer directly or indirectly operates through a permanent establishment in the foreign country. Taxpayers should seize the opportunity to comment on such adverse implications of the proposed foreign branch rules in order to limit their applicability and, thus, the limitation for F.D.I.I. purposes.

HOW IS THE FOREIGN USE OF SALES OR SERVICES ESTABLISHED?

The proposed regulations establish the foreign use differently for sales of property and services.

An interesting point to note is that the proposed regulations treat a partnership as a person for purposes of determining whether a sale of property or services constitutes an F.D.D.E.I. sale or an F.D.D.E.I. service, respectively. One of the results is that an otherwise qualifying sale to a domestic partnership will not qualify as an F.D.D.E.I. sale, whereas the same sale to a foreign partnership may. Thus, the

---

[20] Code §250(b)(3)(A)(i)(VI).

[21] Code §989(a).

[22] Prop. Treas. Reg. §1.250(b)-1(c)(11).

[23] Prop. Treas. Reg. §1.250(b)-3(b)(7).

partnership is not considered an aggregate of its partners for this purpose. This approach is, however, not carved in stone. The Treasury and the I.R.S. request comments on whether applying the aggregate concept for partnerships would be appropriate in certain instances.

Equally important to note is that in addition to licenses, leases, and exchanges, the term "sale" also includes transfers of property resulting in gain or income inclusion under Code §367.[24]

Finally, when a transaction includes the sale of services and the sale of property, it is classified according to the overall predominant character of the transaction.[25]

Sale of Property

Sales of property cannot qualify as F.D.D.E.I. sales if they are made to a U.S. person, even if that person is located outside the U.S.

A sale of property qualifies as an F.D.D.E.I. sale if it is (i) made to a foreign person and (ii) for a foreign use.[26]

Further, F.D.D.E.I. sales are divided into two categories for purposes of determining foreign use: sales of general property and sales of I.P.:

- **Sale to a Foreign Person:** A sale can be treated as made to a foreign person only if documentation reflecting foreign status is obtained by the seller. Small businesses (less than $10 million in gross receipts in the previous taxable year) or taxpayers entering into small transactions (less than $5,000 in gross receipts from a single recipient during the current taxable year) can rely on a mere foreign shipping address.[27]
- **Sale for a Foreign Use:** The rules for determining foreign use are not the same for general property and I.P., as defined by reference to Code §367(d)(4).[28] General property is defined as any property other than (i) I.P., (ii) a security, or (iii) a commodity.[29] For both general property and I.P., documentation requirements must be met. Then, the requirements vary:
    - For general property, foreign use is established if (i) the property is not subject to U.S. use within three years of delivery or (ii) the property is subject to manufacture, assembly, or other processing outside the U.S. before any domestic use of the property.

      The proposed regulations go even further by defining what manufacture, assembly, or other processing means for this purpose: Either, there is a physical and material change to the property, or the property is incorporated as a component into a second product.

---

[24] Prop. Treas. Reg. §1.250(b)-3(b)(7).

[25] Prop. Treas. Reg. §1.250(b)-3(e).

[26] Prop. Treas. Reg. §1.250-4(b).

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

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

[29] For this purpose, securities and commodities are defined in reference to Code §§475(c)(2), 475(e)(2)(B), (C), and (D).

The former is a factual test, while the second is a mathematical one: General property is incorporated as a component into a second product to the extent its fair market value upon delivery to the recipient constitutes 20% or less of the fair market value of the second product when such second product is completed. Special rules exist for fungible goods and transportation property.

- For I.P., foreign use is generally established when revenue is earned from exploiting the I.P. outside the U.S. (and the documentation requirements are otherwise met). It is noteworthy that a sale of I.P. includes a license and any transfer that would result in gain or income recognition under Code §367, including a transfer of I.P. subject to Code §367(d).

Sale of Services for a Foreign Use

Contrary to a sale of property, a service may qualify as an F.D.D.E.I. service even if the transaction is with a U.S. person. The emphasis here is on the non-U.S. location of the recipient and of the property. The determination as to the location of the service recipient is reminiscent of the European V.A.T. rules. It would be interesting to determine to what extent European V.A.T. filings could be used by the recipients to provide the information that the service provider needs in order to meet its documentation requirements. The same logic can be applied to the sale of property.

If the proposed regulations are adopted in their current version, F.D.D.E.I. services will be divided into four mutually exclusive groups:[30]

- **Transportation Services:** The emphasis here is on the origin and destination of the services. Transportation services are services to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation. The services must be provided to a recipient or with respect to property located outside the U.S. The location is determined based on the origin and destination of the service.[31] If both are outside the U.S., the service is an F.D.D.E.I. service. If one is inside the U.S., only 50% of the service is F.D.D.E.I.

- **Property Services:** The emphasis here is on the location of the property. Property services are services, other than transportation services, provided with respect to tangible property located outside the U.S. Substantially all of the service must be performed where the property is located and must result in physical manipulation of the property. The property must be located outside the U.S. throughout the performance of the service. Examples include assembly, maintenance, or repair. For this purpose, “substantially” means that more than 80% of the time providing the service is spent at or near the location of the property.

- **Proximate Services:** The emphasis here is on the location of performance. Proximate services are services, other than property services or transportation services, provided to a recipient located outside the U.S., if substantially all of the service is performed in the physical presence of the recipient or the

---

[30] Prop. Treas. Reg. §1.250(b)-5(b).

[31] Prop. Treas. Reg. §1.250-(b)-5(h).

recipient's employees (in the case of a business recipient). For this purpose, "substantially" means that more than 80% of the time providing the service is spent in the physical presence of the recipient or its employees.[32] Apportionment rules exist for proximate services rendered both within and outside the U.S.

- **General Services:** The emphasis here is on the location of the recipient. General services constitute the default category. They encompass all services not included in the other categories, provided the recipient is located outside the U.S. General services are divided into two broad categories. One consists of services directed at individual consumers located outside the U.S. who use the service for personal needs (business-to-consumer or "B2C"). The other consists of services directed at business recipients located outside the U.S. (business-to-business or "B2B"). For this purpose, a consumer is an individual purchasing the service for personal consumption, and a business recipient is any other recipient (whether or not such recipient is engaged in a trade or business).

  - For B2B services, the service is generally provided to a business recipient outside the U.S. if (i) the business recipient is located outside the U.S., (ii) the service provider's gross income from providing the services is allocated to the business recipient's operations outside the U.S., and (iii) the service provider obtains supporting documentation establishing the location of the service recipient.[33]

    Supporting documentation includes (i) a written statement by the service recipient, (ii) a binding contract specifying the locations of the operations of the business recipient that benefit from the service, (iii) documentation obtained during the course of the provision of the service, (iv) publicly available information establishing the location of the operations, and (v) any other type of documentation prescribed by the I.R.S.[34]

    Special rules exist for business receiving less than $10 million in gross receipts during a prior taxable year.

  - For B2C services, the emphasis is on the location of the consumer. Generally, this location is where the consumer resides at the time the service is provided.[35]

    Here again, documentation requirements must be met, and exceptions exist with regard to small businesses or small transactions.[36]

"Sales of property and services to a domestic unrelated party do not qualify as F.D.D.E.I. sales or services."

As a summary of the above and in line with the provisions of Code §250(b)(5)(B), sales of property and services to a domestic unrelated party do not qualify as F.D.D.E.I. sales or services, even if the domestic unrelated party uses the property and services for a foreign use.

---

[32] Prop. Treas. Reg. §1.250(b)-5(c)(6).

[33] Prop. Treas. Reg. §1.250(b)-5(e)(2)(i).

[34] Prop. Treas. Reg. §1.250(b)-5(e)(3).

[35] Prop. Treas. Reg. §1.250-5(d)(2).

[36] Prop. Treas. Reg. §1.250-5(d)(3).

CAN RELATED-PARTY TRANSACTIONS QUALIFY AS F.D.D.E.I. SALES OR SERVICES?

Yes, if specific requirements are met.

For this purpose, a party is related to a person if it is a member of a modified affiliated group including such person. For this purpose, a "modified affiliated group" is defined as one or more chains of corporations connected through stock ownership with a common parent if (i) the common parent directly owns 50% by vote or value in at least one other corporation and (ii) each of the other corporations is owned directly by one or more of the other affiliated group corporations by at least 50% vote or value. In addition, any person (other than a corporation) is also part of a modified affiliated group if it controls, or is controlled, by a member of such group. For this purpose, control means direct, indirect, or constructive ownership of 50%, by value, of the beneficial interest in such person.

The proposed regulations contain guidance on related-party sales but only with respect to general property and general services. Thus, I.P. and all other categories of services appear to be excluded from the specific related-party rules. Regarding I.P., the preamble to the proposed regulations clarifies that because the general rule for such property is revenue generation from a non-U.S. exploitation of the property, no additional rules are required for related-party sales. Similarly, through their very definitions, proximate services, property services, and transportation services cannot be artificially structured to benefit from the related-party rules.

For general property, two subcategories of rules exist: one for the resale by a related party of the property and one for transactions other than the resale of purchased property. For the former category, a related-party sale is an F.D.D.E.I. sale if, essentially, the requirements for F.D.D.E.I. treatment are met at the level of the related party. Further, an unrelated-party sale must occur by the F.D.I.I. filing date in order for D.E.I. derived from the related-party sale to be treated as F.D.D.E.I.[37] For this purpose, the F.D.I.I. filing date means the filing deadline (including extensions) for the seller's or renderer's income tax return. Amended returns can be filed to claim the benefit of F.D.D.E.I. treatment, should the unrelated-party sale occur after the F.D.I.I. filing date. For the latter category, the sale qualifies as an F.D.D.E.I. sale only if, by the F.D.I.I. filing date, the seller reasonably expects that more than 80% of the revenue earned by the foreign related party from the use of the property in all transactions will be earned from unrelated-party transactions otherwise qualifying as F.D.D.E.I. transactions.

Income derived in connection with general services provided to a related party that is not located in the U.S. is treated as F.D.D.E.I. only if the taxpayer establishes to the satisfaction of the I.R.S. that such service is not substantially similar to services provided by the related party to persons located within the U.S.[38] This essentially constitutes an anti-abuse rule to prevent triangular transactions in which a U.S. service provider provides services to a non-U.S. related party that forwards the output of the services to a U.S. customer. For this purpose, a service is "substantially similar" if the renderer's service is provided to a person located within the U.S. by the related party and either the benefit test or the price test is met:

---

[37] Prop. Treas. Reg. §1.250-6(c).

[38] Code §250(b)(5)(c)(ii).

- **Benefit Test:** The benefit test is met if at least 60% of the benefits conferred by the related-party service are to persons located within the U.S.[39]
- **Price Test:** The price test is met if the renderer's services make up for at least 60% of the price that persons located in the U.S. pay for the service provided by the related party. If the price test is met, the entire F.D.D.E.I. service is not automatically disqualified. Rather, the gross income from the related-party service will be apportioned between the benefits conferred to persons located outside the U.S. and the benefits conferred by the related party to persons located within the U.S.[40]

OTHER RELEVANT PROPOSALS

Although not elaborated in this article, the proposed regulations also address the following points with regard to F.D.I.I.:

- An anti-abuse rule to avoid the 10% Q.B.A.I. reduction
- A disallowance of F.D.I.I. treatment if the taxpayer has knowledge, or reason to know, that such treatment should not apply
- Rules for consolidated groups
- Reporting requirements

CONCLUSION

To summarize, the main focus of the proposed regulations seems to be the tracking of abusive scenarios in which foreign use appears on paper but the property or services are channeled back to the U.S. market. While the proposed regulations also address several questions raised by practitioners, they still leave open practical implications – in particular, relating to the documentation requirements for F.D.I.I. deduction eligibility.

Furthermore, before utilizing the F.D.I.I. regime, U.S. corporations would be wise to determine whether the benefits outweigh the documentation and compliance burdens. Modeling that focuses on benefits without factoring in costs of compliance will not provide a complete answer. Taxpayers should consult with tax counsel for a comprehensive analysis before making a decision.

Finally, taxpayers and their counsel are invited to comment on the proposed regulations – in particular, relating to the ordering rules for computing F.D.I.I., the negative impact of an extensive definition of foreign branch operations that are excluded from F.D.I.I., and practical implications of the suggested documentation requirements.

---

[39] Prop. Treas. Reg. §1.250(b)-6(d)(2)(i).

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

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*