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FDII deduction for foreign-owned US companies- an overlooked opportunity?

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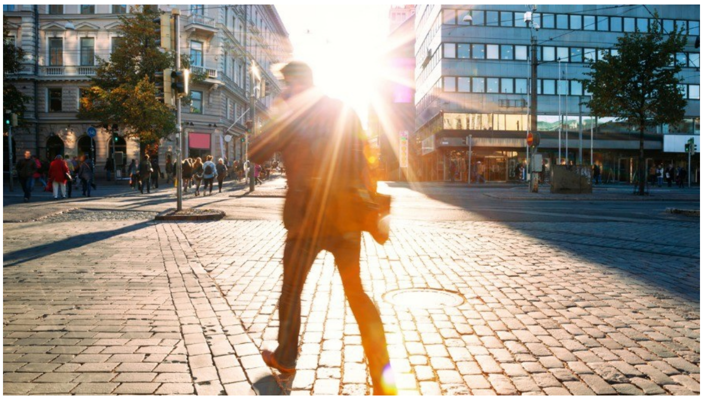

This article was originally published in Bloomberg Tax and discusses the current status of the Foreign-Derived Intangible Income (FDII) rules and the availability of the FDII deduction with respect to income realized by foreign-owned U.S. companies from sale of goods or rendering of services to foreign affiliates.

For foreign multinationals doing business in the U.S. through a U.S. branch or subsidiary, some portion of their U.S. profits will likely be subject to U.S. income tax. The Tax Cuts and Jobs Act of 2017, P.L. 115-97, introduced many changes relevant to such companies, including a reduction of the top federal corporate income tax rate from 35% to a flat 21%.

Also introduced was a deduction for FDII reported by domestic C corporations. Subject to the limitation described below, the deduction is equal to 37.5% of a qualifying domestic corporation's FDII for tax years beginning in 2018 and before 2026, resulting in an effective U.S. federal income tax rate of 13.125% on such income. (For taxable years beginning after 2025, the amount of the deduction is reduced to 21.875%, resulting in an effective federal rate of approximately 16.4% on FDII).

The FDII deduction is available to foreign multinationals with U.S. subsidiaries. It is not unusual for such subsidiaries to sell goods or provide services to foreign affiliates. For example, a U.S. subsidiary might provide marketing or R&D services to a foreign affiliate. Depending on their specific facts, income derived from provision of the services may qualify for the FDII deduction.

The FDII deduction has received a cool reception from taxpayers and their advisers, mainly due to uncertainty over its sustainability (i.e. risk of a successful WTO challenge) and the practicality of the documentation requirements. Subject to one exception discussed below, neither of those concerns should be a practical obstacle for inter-company transactions of foreign multinationals.

Typically, a foreign-parented multinational enterprise would not need to make changes to its company structure or operations to avail itself of the deduction; if the FDII regime is modified or repealed in the future, it has lost nothing by availing itself of the deduction. Additionally, where transactions occur between commonly controlled parties, satisfying the documentation requirements will often be manageable.

Substantive Requirements

FDII of a domestic C corporation is determined under a formula. Essentially, FDII is the income of a domestic C corporation (subject to certain exclusions and net of attributable deductions) derived from:

- sales of property to foreign persons for foreign use; and
- provision of services to a recipient or with respect to property located outside the U.S.

In either case, such income is reduced by a notional 10% return on the corporation's depreciable tangible property. The amount of FDII and global intangible low-taxed income may not exceed the total taxable income of the domestic corporation. The FDII deduction is 37.5% of FDII, as limited (21.875% for taxable years beginning after 2025).

For sales of property (including leases and licenses), the corporation must establish that the customer is a foreign person and that the property has been sold for foreign use. Proposed regulations issued under section 250 on March 4, 2019 (the "proposed regulations") described these requirements.

Under the proposed regulations, a customer will be considered a foreign person as long as the customer is neither an individual citizen or resident of the U.S., nor a legal entity organized under domestic laws. What constitutes "foreign use" depends on the type of property. A sale or license of intangible property (IP), such as copyrights, trademarks, patents, inventions, and formulae satisfies foreign use requirements only to the extent that the revenue it generates is deemed to arise from exploitation of the IP outside the U.S.

Planning Point: Due to the complexity of making these determinations, if feasible, it may make sense for IP transactions to be split up and governed by two separate contracts—one governing U.S. rights and one governing the rest of the world.

All other property (excluding certain property used in international transportation) satisfies the foreign use requirement if it is not used domestically within three years following its date of delivery, or it is subject to manufacture, assembly or other processing outside the U.S. before being used within the U.S.

The proposed regulations categorize services into five categories. In the context of foreign-owned U.S. companies providing services to affiliates, the category likely to be most relevant is general services provided to business recipients. The other categories are general services provided to consumers, property services (certain services provided with respect to tangible property performed substantially outside the U.S.), transportation services, and proximate services (services other than property services or transportation services if substantially all of the services are performed outside the U.S. in the presence of the recipient or its employees).

Under the proposed regulations, general services satisfy the foreign use requirement to the extent that the benefit of the services is considered to run to the recipient's business locations outside the U.S. In cases where a service benefits a recipient's business at large, or reliable information on the location of benefits is unavailable, the service provider's gross income is allocated ratably to all of the recipient's operations using a reasonable method (e.g. by reference to the recipient's revenues, or the service provider's time spent or costs incurred).

Documentation Requirements

Sales and services otherwise eligible for the FDII deduction will not qualify unless specific documentation requirements are satisfied.

Under the proposed regulations, documentation may be relied upon only if:

- it has been obtained by the seller or service provider no later than the date by which the seller/service provider is required to file a federal income tax return reporting the income from the services;
- it was obtained no earlier than one year before the date of the relevant sale or provision of services; and
- as of the tax return filing date, the seller/service provider does not know or have reason to know that the documentation obtained is unreliable or incorrect.

The specific documentation requirements vary, depending on the type of property sold or service provided. For property sales, the status of the recipient as a foreign person can be established by a valid government-issued ID, documentation establishing that a legal entity is organized or created under the laws of a foreign jurisdiction (e.g. articles of organization or other constitutional documents), documents filed with a government agency (e.g. a securities regulatory agency), or a written statement that the recipient is a foreign person.

Documentation required to establish foreign use depends on the type of property sold. For example, in the case of general services provided to a business recipient, the business recipient's location may be established by a binding contract, other ordinary course of business documentation, or a written statement from the business recipient specifying the locations of the recipient's operations that benefit from the services, or from publicly available information that establishes the locations of operations of the recipient.

The proposed regulations also include substantially reduced documentation requirements for small businesses (i.e., service providers whose gross receipts for the prior taxable year are under $10 million) and for small transactions (i.e. those for which gross receipts from a particular recipient are under $5,000 for the year). Due to the low thresholds, those exceptions may not be helpful in the context of type of inter-company transactions contemplated by this article.

Related Party Rules

Sales and services to related parties may qualify for the FDII deduction if they satisfy certain additional requirements.

For purposes of these rules, parties are generally considered to be related if they are members of an affiliated group of companies connected by more than 50% ownership. These additional requirements do not apply to certain related party transactions, notably IP transfers. Where a sale of property is made to a foreign related party, the outcome depends on whether:

- the property is resold to an unrelated party or parties (either as originally purchased or as a component of other property sold); or
- the property is used in the process of providing property or services to unrelated parties.

Planning Point: Where property is sold to a foreign related party for resale, and the unrelated party transaction has not occurred before the relevant tax return filing date, the FDII deduction cannot be claimed on the seller's original tax return, but may be claimed subsequently on an amended return when an unrelated party transaction meeting those requirements occurs, provided that the statute of limitations remains open.

In the second case, the FDII benefit may be claimed if the seller in the related party sale reasonably expects that more than 80% of the revenue earned from the use of the property received in the related party transaction will be derived from unrelated party sales or services transactions that meet the substantive FDII requirements (but not necessarily the documentation requirements). For example, assume a U.S. subsidiary sells manufacturing equipment to a foreign affiliate and the equipment is used to produce inventory sold worldwide. The requirement is met if the foreign affiliate has a reasonable expectation that more than 80% of the revenue from that inventory will be from sales to foreign unrelated persons for foreign use.

Note that, in the case of a provision of property to a foreign affiliate that is resold (rather than used to produce other property or provide services) to foreign unrelated parties, the documentation requirements become a practical issue for foreign-parented multinational companies.

A related party services transaction may qualify for the FDII deduction if the services rendered are not considered to be "substantially similar" to services provided by the related party service recipient to a person or persons located in the U.S. Under the proposed regulations, the services provided by the related party service recipient are considered to be substantially similar services if:

(i) 60% or more of the benefits conferred by the related party service ultimately accrue to persons located in the U.S.; or

(ii) 60% or more of the price paid by the persons located in the U.S. is attributable to the related party service.

For purposes of these tests, a service is generally considered to provide a benefit if it directly results in a reasonably identifiable increment of economic or commercial value that enhances the service recipient's commercial position, or may be reasonably anticipated to do so. Under a proportional savings rule, if a related party service is deemed to be substantially similar to an unrelated party service rendered to persons located in the U.S. only under the test in (ii) above, the portion of the related party service not attributable to the services provided by the related party service recipient may still qualify as for the FDII deduction.

The proposed regulations provide examples illustrating the application of these tests. The examples posit a foreign corporation that has entered into a contract to provide design consulting services to a restaurant company, and has subcontracted a portion of that work to its U.S affiliate. The examples indicate repeatedly that the services rendered by the U.S. subsidiary will serve no purpose other than to enable the foreign parent to provide its services under the contract.

One inference reasonably drawn from the examples is that related party services generally will not be considered substantially similar to unrelated party services unless there is some direct connection between them. Without such a direct connection, it would be difficult to apply either of the 60% attribution tests in any meaningful way. In some cases, there will not be a direct connection between services provided by a U.S. subsidiary to a foreign affiliate and other unrelated party services provided by the foreign affiliate (e.g. R&D services).

Opportunity for Foreign Multinationals

Transactions undertaken between U.S. subsidiaries of foreign multinationals and their foreign affiliates may generate U.S. taxable income that satisfies the requirements for the FDII deduction.

The documentation requirements set out in the proposed regulations are a significant hurdle to claiming the deduction. These requirements could be prohibitive in the context of an unrelated party transaction. The requirements put U.S. companies in a position of having to request information and certifications not previously required from foreign customers, and which customers may not always be willing or able to provide. Moreover, in some cases, the use of property sold will need to be tracked over a period of years—e.g., to make a determination as to whether it has become subject to domestic use within three years of its initial sale. Some customers may not currently track this information.

The concerns described above are not completely eliminated in the case of transactions between commonly controlled parties, but are often greatly diminished. In particular, the documentation requirements may be manageable in the context of related party transactions if the relevant personnel are properly trained and the required documentation is built into protocols (subject to the caveat that, for sales of property to a foreign affiliate that are resold to unrelated buyers, the proposed regulations require the foreign affiliate to comply with the documentation rules in connection with those resales). It is also possible that the documentation requirements laid out in the proposed regulations will be liberalized in the final regulations.

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