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FDII Proposed Regulations: Accepted With Constructive Edits in the US But the EU Reiterates Concern

On March 4, 2019, Treasury and the Internal Revenue Service (IRS) released proposed regulations providing guidance for implementation of Section 250, which provides a deduction for foreign derived intangible income (FDII).

Various domestic groups submitted comments on the proposed regulations, including the United States Council for International Business (USCIB), the US Chamber of Commerce (USCC), the Silicon Valley Tax Directors Group (SVTDG), the Alliance for Competitive Taxation (ACT), the Aerospace Industries Association (AIA), and the Information Technology Industry Council (ITIC). Generally pleased with the new FDII deduction and aiming to qualify for it, these domestic groups used their comment letters to suggest improvements to the proposed regulations. Despite the diverse interests of these domestic groups, there are two key issues in the proposed regulations that were discussed by many of them – (1) the documentation requirements and (2) the foreign use and foreign operations provisions.

On the other side of the Atlantic, the Delegation of the European Union to the United States (EU Delegation) has threatened protective action in response to a FDII regime that it views as discriminating against foreign sellers, violating World Trade Organization (WTO) rules, and incentivizing tax avoidance.

Below we provide a brief overview of the FDII deduction and a summary of the key comments recently submitted, examine the EU Delegation's position, and provide some comments from a tax policy perspective on what to expect next.

Overview of FDII Deduction

Section 250 was enacted to provide a deduction to taxpayers who engage in exporting goods and services from the US. This deduction results in an effective rate of tax of 13.125% on qualifying income. This provision is intended to work in parallel with the global intangible low-taxed income (GILTI) rules of Section 951A, which imposes a tax on certain intangible income earned outside the US. FDII is the carrot, and GILTI is the stick. Read more about this interaction.

Submitted Comments

As noted previously, the diverse group of commentators found common ground around two key issues – documentation requirements, and the foreign use and foreign operations provision. We address each of these below.

Minimize Documentation Requirements

Many of the submitted comments suggest that the proposed regulations require businesses to create and maintain superfluous, difficult-to-obtain documentation in lieu of more practical documentation already existing in the ordinary course of business. Before the permanent rules come into effect, a temporary documentation rule allows taxpayers, for taxable years beginning on or before March 4, 2019, to use "any reasonable documentation maintained in the ordinary course of the taxpayer's business" to satisfy the documentation requirements. This means that taxpayers may use documents such as invoices, purchase orders, packing slips, bills of lading, and similar documents already utilized in their business to show the requisite foreign use/person. The USCC suggests a lengthened five-year transition period, while the SVTDG requests that the permanent rules be replaced by the temporary rule currently in effect for most taxpayers.

Once the transition period has expired, the proposed regulations require businesses to establish a customer's status as a foreign person with narrow types of satisfactory documentation. A taxpayer making a sale or providing a service to an individual is required to have either (1) a written statement that the recipient is a foreign person or (2) a valid form of identification issued by a foreign government or agency. There are three ways to prove that an entity is a foreign person: (1) a written statement by the recipient that the recipient is a foreign person; (2) documentation that establishes that the entity is organized or created under the laws of a foreign jurisdiction; or (3) documents filed with a government that provide the foreign jurisdiction or residence of an entity. The USCIB notes that many of the companies attempting to comply with FDII documentation requirements also must comply with VAT documentation requirements with respect to the same transactions. Therefore, FDII compliance could be simplified by allowing companies to use this VAT documentation to prove the common issue of destination of ultimate use. The proposed regulations grant an exception to certain sellers with more modest gross receipts, such that they may rely on the shipping address of the recipient to document the foreign person requirements. Noting the administrative burden imposed by the proposed regulations for large companies and the competitive disadvantage they face *vis-à-vis* foreign sellers, the USCC suggests that the final regulations provide a non-exhaustive list of acceptable documentation, including "the shipping location of the recipient for all taxpayers regardless of size."

The proposed regulations require businesses to document foreign use of general property and the foreign status of business recipients of general services. For the former, the recipient of property must provide a written statement, or include in a binding contract, language about the standard of property for "foreign use." For the latter, a renderer of services must obtain information regarding the specific locations of the operations of the business recipient and determine how to allocate the benefit among such locations. Noting the unrealistic nature of these demands, many submitted comments recommend the following rebuttable presumption for establishing foreign use. "A taxpayer may show reasonable documentation regarding the sale to persons outside the United States by using documentation created in the ordinary course of business, unless the taxpayer knows, or has reason to know, that the general property will be used in the United States." The ITIC favors more relaxed documentation rules for taxpayers with a sufficiently large number of customers or transactions (for instance, more than 10,000). The ITIC also recommends that these larger taxpayers be permitted to rely on the shipping address or billing address, as applicable, to establish that property is for foreign use or a recipient is located outside the US. The ACT proposes the following taxpayer-friendly alternative to the documentation rules. "Taxpayers lacking the applicable documentation on or before the FDII filing date nevertheless could be permitted to claim FDII benefits on the return for the taxable year of the applicable sale or service, provided that the required documentation is obtained within 36 months after the FDII filing date."

Virtually all of the submitted comments stated that the requirement that "reliable" documentation must be obtained no earlier than one year before the "date of the sale or service" is far too onerous. Numerous comments emphasize the problem this rule creates with respect to multiyear contracts and contracts executed years in advance of the "date of the sale" and advocate removing the rule altogether. The ITIC suggests an exception for multiyear contracts by providing that documentation obtained for the first year of a multiyear contract could be permitted to be used for each year of the contract without requiring updates or validation of the documentation, unless the taxpayer knows or has reason to know of a material information change or there is a subsequent change in the foreign parties to the contract. Alternatively, the AIA recommends that Treasury amends "date of the sale" to be "date of contract execution" so that manufacturers executing contracts years in advance of the "date of the sale" are able to use the contract for reliable FDII compliance documentation at least once.

Modify Foreign Use and Foreign Operations Provisions

In addition to concerns regarding documentation, a majority of the submitted comments note that clarity on "foreign use" and "foreign operations" is required. The sale of general property is for a foreign use if the property is subject to manufacture, assembly or other processing outside the US. To qualify as manufactured, assembled or processed, general property must be either "subject to a physical and material change" or incorporated into another product as a component. The submitted comments note that this provision appears to be derived from past versions of regulations where the taxpayer already had such information because it related to the company's own activities. In this case, however, the taxpayer may not have knowledge regarding the extent of physical or material change to the property sold to an unrelated party. The commenters propose that the definition of "physical and material change" includes explicit language establishing the type of assembly activities that will qualify, rather than leaving taxpayers to guess if their particular facts and circumstances will be sufficient. The revised definition would affirm that assembly activities, which are substantial in nature and generally considered to constitute the manufacturing or production of property that is different from the property that was purchased, would constitute a "physical and material change."

The submitted comments also express support for adding a safe harbor to the proposed regulations on component manufacturing. As written, the proposed rules provide that general property will be treated as for foreign use if the property is incorporated into another product as a component, such that the fair market value (FMV) of the general property sold totals no more than 20% of the FMV of the completed product. Just as a general-property seller may not have knowledge regarding a purchaser's subsequent "physical or material change" to property, so is a component seller often unclear as to the particular final product its component resides within and what percentage of total completed product FMV to ascribe to that component. A suggested fix to this problem is a safe harbor that would allow taxpayers to meet the 20% test by obtaining facts from publicly available data about the purchaser's completed products, market research, and the like. For instance, even if a computer chip seller did not know which of its various computer chips went into a computer company's multiple computer models, it could compare the computer company's revenue (denominator) to the cost of the purchased computer chips (numerator) through publicly available information, and the resulting fraction would determine the foreign use question. The SVTDG recommends easing the FMV requirement such that the required fraction would be just one-half, rather than one-fifth.

The proposed regulations' requirements for proving foreign operations was also the subject of many submitted comments. While the code's text requires a services customer to be located outside the US, the proposed regulations allocate general services to foreign operations only if the customer has a location where it maintains an office or other fixed place of business. The service provider is responsible for providing documentary evidence linking services rendered to the customer's foreign operations (i.e., particular locations). The USCC and the AIA request that the final regulations specify that a service is provided to a business recipient located outside the US if the service is *not* provided to a business recipient located within the US. Alternatively, the USCC suggests allowing the service provider to use publicly available information about the recipient's geographic allocations of earned revenue to determine the appropriate FDII location of foreign operations. As a further even narrower alternative, because a foreign office may still not capture a customer's operations in outer space, the ocean or international airspace, the USCC and the AIA advocate explicitly providing that regular and continuous operations in the aforementioned non-US, (potentially) non-foreign places are treated as foreign operations.

EU Sees FDII as a WTO Violation

Prior to the passage of the Tax Cuts and Jobs Act (TCJA), the European Commission sent Treasury Secretary Mnuchin a December 12, 2017 letter expressing concern that the US tax bill contained "elements that risk seriously hampering trade and investment flows between our economies." The proposed deduction for FDII was a key component of that concern on the basis that "the preferential tax treatment would also be given to intellectual property that was initially created outside the U.S." In the Commission's view, FDII is a harmful tax practice "contrary to the OECD Base Erosion and Profit Shifting (BEPS) Action 5 report" and a prohibited export subsidy in violation of "the WTO Agreement on Subsidies and Countervailing Measures." The concerns expressed, of course, did not prevent the passage of the TCJA, nor did they lead to any significant amendment to the design of the FDII rules.

Two months after the publication of the proposed FDII regulations, the EU Delegation submitted further forceful comments to Treasury in relation to the introduction of the new regime. In its comments, the EU Delegation reiterated its assertion that the FDII regime "(1) most likely breach[es] U.S. obligations under the World Trade Organization (WTO) …, and (2) [is] not fit to reduce tax avoidance and aggressive tax planning."

The WTO complaint likely has the most potential to result in changes being made to the FDII rules. In essence, the EU views FDII as an unfair subsidy (i.e., it exempts certain income from tax that would otherwise be due) for US corporations, which is calculated using an entirely mechanical methodology based solely on export performance. On this basis, the EU Delegation contends that FDII violates WTO rules. If that is right, trading partners adversely affected are entitled to impose retaliatory sanctions, either having first obtained approval from the WTO or simply unilaterally. It is probably this entitlement that helps explain the Commission's thinly veiled threat "to protect the economic interest of the EU in light of discriminatory rules and practices" as a tool to "intensify … cooperation on ways to remove any discriminatory elements of the U.S. tax reform". Some sort of legal challenge to FDII in the WTO seems inevitable and a US taxpayer, with activities and interests in the EU, should exercise due caution when calculating its entitlement to a deduction under FDII.

It is also important to understand the EU objections on FDII in a wider, global context. Three factors are worthy of brief note.

First, there is the possibility that negotiations for a comprehensive free trade agreement (FTA) between the EU and the US will commence in the near future. Whatever the validity of the EU's objections to FDII, the prospect of an EU-US FTA is a much larger issue. This is not the first time the US and the EU have clashed over export subsidies, nor is it likely to be the last time. It is entirely possible that FDII itself, and the EU's threats (and any countermeasures that result), are part of early stage positioning for the negotiations to come.

Second, there is a growing importance of intangible property as a value-creator in an interdependent, globalized, increasingly digitalized economy. Algorithms have replaced industrial factories, and data has replaced widgets; intangible assets have replaced tangible assets. Intangible property has always moved more easily across borders, helping drive "scale without mass" and the erosion of a nation state's taxable base, but the digitalization of the global economy exacerbates the problem. GILTI and FDII are tools the US is using to protect and promote American intellectual property. The EU has laid out its own proposals for a super-deduction for research and development (R&D) costs to promote innovation. However, the EU's proposals are narrower in scope than FDII and further restricted by the EU's support for the "Modified Nexus Approach" (resulting from Action 5 of the OECD's BEPS project) ensuring only the entity undertaking the relevant R&D can claim the deduction. These are different approaches but both, ultimately, aimed at the same end: protecting self-interest in, and taking a degree of control over, the unfolding (so-called) fourth industrial revolution. Even if the EU does lodge a complaint with the WTO, it may simply be a tool to encourage the US back to the multilateral fold by virtue of incorporating some variant of the "Modified Nexus Approach" into FDII.

Third, political landscapes are changing. FDII has been effective for tax years beginning after December 31, 2017, but the EU has so far not carried through on its threats. To date, the EU's R&D plan (part of its revived proposals for an EU-wide Common Corporate Tax Base (CCTB)) has failed to obtain the unanimous support of the Member States it needs and, it seems, is a long way from coming to fruition. In addition, Brexit has proved to be a particularly restrictive diversion for both the UK (traditionally a leading voice in forming EU tax policy) and the Commission. It is not possible to rule out WTO action and countermeasures completely, but these factors, and the imminent end of the current Commission in October 2019, help explain the lack of progress to date. A new Commission, under new leadership, with the power to steer EU tax and trade policy priorities, will take control on November 1, 2019 (the same day the UK is, currently at least, expected to leave the EU), and could provide renewed impetus. Add to that the expectation that the OECD will recommend a consensus-based solution for the tax challenges posed by the digitalization of the global economy by the end of 2019, and that 2020 is a US Presidential-election year, it is obvious that further developments in this area are almost certain and deserving of close attention.

Washington DC and EU Policy Perspectives: Any Middle Ground?

While the political landscapes are certainly changing abroad, Treasury and the IRS are working to fine-tune the implementation of the proposed FDII regulations. By way of reminder, Treasury and the IRS published the proposed rules on March 6, 2019, and the public comment period ended May 6, 2019. Looking ahead, Treasury and the IRS must now sort through the many comments offering recommendations to tweak the proposed rules.

Comments From the Business Community

Notable domestic business groups have submitted comments to the IRS, requesting changes to a wide array of topics within the proposed FDII and GILTI regulations. In particular, on May 1, the USCC submitted comments and recommended changes. The USCC urged Treasury and the IRS to continue to work closely with the business community to implement the recent tax changes in a manner to ensure "as little disruption as possible to normal business operations" and to encourage the US economy to "achieve its true growth potential." On May 6, the Tax Executives Institute (TEI), a prominent association of in-house tax professionals, submitted comments to the IRS. TEI's comments primarily focused on the proposed regulations' information requirements for documenting the "foreign use" of property or services eligible for the FDII deduction. It remains to be seen how these comments from the business community will impact the outcome of the proposed regulations, but will be an important issue to monitor over the coming weeks.

IRS Public Hearing on July 10

In fact, we may have a much clearer picture of where the proposed regulations are headed by mid-summer. On July 10, the IRS plans to hold a public hearing on the proposed FDII and GILTI regulations. For speakers who wish to discuss certain topics at the hearing, the IRS requires speakers to submit topic outlines by July 1. After July 1, the IRS will release an agenda, providing some insight on what topics the IRS plans to address at the hearing. This will surely be a consequential few weeks for FDII, and it will be interesting to see whether this major element of international tax reform undergoes significant changes.

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