Tax Notes

Final FDII Regulations Released: Is This a Deduction You Can Use?

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The Treasury recently released final regulations regarding the application of the deduction for foreign derived intangible income (FDII). The regulations are generally taxpayer-friendly, loosening the extensive documentation requirements required to take the deduction that had appeared in the proposed regulations.

In addition to detailing key changes in the proposed regulations, this article will explain the FDII rules, which are a welcomed deduction that may be underused. While the name refers to "intangible income," the calculation does not require that the income be derived from intellectual property to qualify for the deduction; sales of goods or provision of services to foreign persons could also qualify. All businesses with foreign customers should consider their potential eligibility.

What is FDII?

Enacted as part of the Tax Cuts and Jobs Act (TCJA), IRC §250 provides a deduction on intangible income earned from U.S. sales to foreign customers, known as FDII. The deduction is 37.5% of FDII, bringing the net effective tax rate on this income to 13.125%. (After 2025, the deduction is 21.87%, for a net effective tax rate of 16.41%.) The intent is to make it more desirable to develop and continue to own intangible property in the United States.

Whether income is derived from intangibles is not determined using any sort of tracing method. Instead, FDII is the product of a formula:

(Foreign Derived Deduction Eligible Income / Deduction Eligible Income) * Deemed Intangible Income

> **Foreign Derived Deduction Eligible Income (FDDEI)** is income from the sale of property to a foreign person for a foreign use or the provision of services to a person (or with respect to property) outside the United States.
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> **Deduction eligible income** is simply a taxpayer's income, with certain exceptions.
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> **Deemed intangible income** is deduction-eligible income over a 10% return from a taxpayer's tangible assets. (If this looks familiar, that's because deemed intangible income is calculated in basically the same way GILTI is calculated for the income of foreign corporations.)

For example, let's say that a corporation has FDDEI of 100 and total deduction eligible income of 200. If deemed intangible income is also 200, then FDII is 100 (100 of FDDEI over 200 of deduction eligible income, multiplied by 200 of deemed intangible income). The corporation's FDII deduction is 37.5, reducing their taxable income to 62.5. The corporation's tax on that income would be 13.125.

FDDEI must be derived from sales (or services provided) to unrelated parties, although a sale to a foreign related party which is followed by a sale to unrelated parties does qualify. Sales may include licenses or leases.

Taxpayers with foreign sales attributable to their U.S. entity should consider whether they could be eligible for the FDII deduction. Unless the foreign sales are generated from a very significant base of tangible assets, a taxpayer is likely to have some FDII deduction eligibility. However, properly documenting the

sales that generate the FDII deduction is a key component in taking the deduction. That's where the regulations come in.

The Final Regulations

The proposed regulations, issued in 2019, created specific documentation requirements to establish that a transaction generated FDII. The taxpayer taking the deduction needed written documentation that the purchaser was a foreign person and that the property would be subject to foreign use. Many comments to the proposed regulations noted that the documentation requirements were burdensome and would likely disqualify otherwise eligible taxpayers. Essentially, taxpayers needed to have planned out their documentation procedure in advance before being eligible for the deduction.

The final regulations remove the specific documentation requirements for establishing that the purchaser of property is foreign and that non-intangible property or services are purchased for foreign use when the purchaser is an unrelated party. Taxpayers need only to meet the general tax law requirements of showing their eligibility for a deduction. For example, under the prior regulations, a taxpayer needed a written statement or proof of a purchaser's foreign person status; under the final regulations, foreign person status for the purchase can be presumed if the billing address is outside the United States.

The final regulations relax, but do not remove, the specific documentation requirements for establishing foreign use on sales of property for resale or further processing outside the U.S., as well as foreign use of intangible property. While taxpayers must substantiate these points, the required documents are far less onerous than in the proposed regulations. Under the final regulations, credible evidence obtained in the ordinary course of business can be used to substantiate foreign use if, for example, there is not a written contract stipulating that the property can only be used outside the U.S. Notably, though, the substantiating documents must be in existence as of the FDII filing date and must be provided to the IRS upon request.

These changes eliminate many of the concerns that the documentation requirements could exclude eligible taxpayers. While the substantiating documents must be in existence on the FDII filing date, they are far more likely to be things that the taxpayer already collects in their ordinary course of business, as opposed to the more specific required documents in the proposed regulations.

The regulations apply for tax years beginning in 2021, although transition rules do apply for prior years.

Contact Us

PKF O'Connor Davies has many International Tax Experts to guide you through this process. We welcome the opportunity to answer any questions you may have related to this topic.

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