DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9901]

RIN 1545–BO55

Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). This document also contains final regulations coordinating the deduction for FDII and GILTI with other provisions in the Internal Revenue Code. These regulations generally affect domestic corporations and individuals who elect to be subject to tax at corporate rates for purposes of inclusions under subpart F and GILTI.

DATES: Effective Date: These regulations are effective on September 14, 2020.

Applicability Dates: For dates of applicability, see §§1.250–1(b), 1.962–1(d), 1.1502–50(g), 1.6038–2(n)(4), 1.6038–3(i), and 1.6038A–2(g).


SUPPLEMENTAL INFORMATION:

Background

Section 250 was added to the Internal Revenue Code (“Code”) by the Tax Cuts and Jobs Act. Public Law 115–97, 131 Stat. 2054, 2208 (2017) (the “Act”), which was enacted on December 22, 2017. On March 6, 2019, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG–104464–18) under sections 250, 962, 1502, 6038, and 6038A in the Federal Register (84 FR 8188) (the “proposed regulations”). Corrections to the proposed regulations were published on April 11, 2019, and April 12, 2019, in the Federal Register (84 FR 14934 and 84 FR 14901, respectively). A public hearing on the proposed regulations was held on July 10, 2019. The Treasury Department and the IRS also received written comments with respect to the proposed regulations.

All written comments received in response to the proposed regulations are available at https://www.regulations.gov or upon request. Terms used but not defined in this preamble have the meaning provided in these final regulations.

Summary of Comments and Explanation of Revisions

I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking. Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with future guidance projects.

II. Comments on and Revisions to Documentation Requirements and Applicability Dates

A. Documentation Requirements for Foreign Persons, Foreign Use, and Location Outside the United States

As described in parts VII.B, C.1, and D.1 and VIII.B.1 and B.2.c of this Summary of Comments and Explanation of Revisions section, the proposed regulations provided that to establish that a recipient is a foreign person, property is for a foreign use (within the meaning of proposed §1.250(b)–4(d)(3)(iii) and (e)(3)), or a recipient of a general service is located outside the United States (within the meaning of proposed §1.250(b)–5(d)(2)), the taxpayer must obtain specific types of documentation described in proposed §§1.250(b)–4(c)(2), (d)(3), and (e)(3) and 1.250(b)–5(d)(3) and (e)(3). The proposed regulations also provided a transition rule whereby for taxable years beginning on or before March 4, 2019, taxpayers could use any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the United States, as applicable, in lieu of the specific documentation described in the regulations, provided that such documentation meets certain reliability requirements described in proposed §1.250(b)–3(d). See proposed §1.250–1(b). The preamble requested comments on this special transition rule.

Several comments recommended either making this transition rule permanent or extending it for a certain period after the regulations are finalized. The comments recommending that the transition rule be made permanent indicated that the documentation described in the proposed regulations may be difficult, if not impossible, to obtain in the ordinary course of business. The comments noted that customers are highly reluctant to provide some of the types of documents that the proposed regulations described.

A comment noted that the documentation rules in the proposed regulations could require taxpayers to renegotiate contracts or make inquiries of their customers that could interfere with the customer relationship. Several comments were concerned with how the documentation rules and, in particular, the reliability requirements would apply to business models with longer-term contracts, especially those entered into during the 2019 tax year.

The comments that requested extending the transition rule suggested that this would allow adequate time for the IRS to gain experience with the types of documentation taxpayers collect in the ordinary course of business, and for taxpayers to gain experience complying with such rules by developing or improving internal compliance systems. Alternatively, some comments suggested that the next issuance of regulations should be in temporary form to allow additional time to consider the reasonableness of the documentation requirements before final regulations are issued and to allow taxpayers more time to identify distortive returns.

Other comments recommended changes to the documentation rules if the final regulations do not make the transition rule permanent. Several comments suggested that any list of suitable documents (for either property sales or services) should be non-exclusive and include more documents obtained in the ordinary course of business. Some comments recommended allowing the use of documentation methods similar to those for sales of fungible mass property under proposed §1.250(b)–4(d)(3)(iii) such as market research, statistical sampling, economic modeling or other similar methods to show foreign person status or foreign use.

The final regulations address these comments in several ways. First, the final regulations eliminate the requirement in the proposed regulations to obtain specific types of documents to
establish foreign person status, foreign use with respect to sales of certain general property that are made directly to end users, and the location of general services provided to consumers. The Treasury Department and the IRS have determined that requiring specific documentation with respect to these requirements is difficult given the variations in industry practices and is not necessary to achieve the purpose of the statute. Accordingly, the final regulations remove the specific documentation requirements to establish foreign person status and foreign use with respect to certain sales of general property and the location of a consumer of a general service. However, as explained in more detail in part II.D of this Summary of Comments and Explanation of Revisions section, as with any deduction, taxpayers claiming a deduction under section 250 bear the burden of demonstrating that they are entitled to the deduction. Therefore, the general requirement for taxpayers to substantiate their deductions will apply without any additional specific requirements as to the content of information or documents.

Second, the final regulations adopt a more flexible approach regarding the types of substantiation required for foreign use with respect to sales of general property to non-end users, foreign use with respect to sales of intangible property, and with respect to determining whether services are performed for business recipients located outside the United States. Although the substantiation requirements in the final regulations are more specific as to the nature of the information required, they are not limited to a narrow set of documents. The requirements also do not contain the specific reliability requirement set out in the proposed regulations because the reliability of documents or information can differ depending on the circumstances. For example, documents created in advance of a sales date (such as a long-term sales contract) may be as reliable as documents created at the time of sale depending on the facts and circumstances. Further, the final regulations continue to require that the substantiating documents be supported by credible evidence. See part II.C of this Summary of Comments and Explanation of Revisions section.

Finally, the applicability dates of the regulations have been revised, and taxpayers are permitted to rely on the proposed regulations for taxable years before the final regulations are applicable. See part II.F and XII of this Summary of Comments and Explanation of Revisions section.

B. Specific Substantiation for Certain Transactions

In lieu of the documentation requirements in the proposed regulations, with respect to sales of general property to recipients other than end users, sales of intangible property, and general services provided to business recipients, the final regulations provide substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used. See §1.250(b)–3(f). For these transactions, specific substantiation requirements are needed to ensure that taxpayers make sufficient efforts to determine whether the regulatory requirement is met. Therefore, with respect to these transactions, the final regulations describe the type of information necessary to meet the substantiation requirements. The specific ways a taxpayer must substantiate these elements are described in parts VII.C.9, VII.D.2, and VIII.B.2.d of this Summary of Comments and Explanation of Revisions section. The substantiation requirements are modeled after substantiation rules under section 170 (requiring substantiation through receipts for certain charitable deductions) and section 274(d) (requiring substantiation by adequate records or a taxpayer statement with corroborating evidence). The Treasury Department and the IRS have determined that requiring a taxpayer to specifically substantiate certain transactions—in particular transactions where the relevant facts needed to satisfy the rules are generally in the hands of a third party with a business relationship with the taxpayer—is necessary and appropriate for establishing “to the satisfaction of the Secretary” that property is sold for a foreign use or that services are provided to persons located outside the United States. See section 250(b)(4) and (b)(5)(C).

C. Timing To Obtain, Maintain, and Provide Specific Substantiation

In general, the substantiation rules require that the substantiating documents with respect to certain transactions that give rise to foreign-derived deduction eligible income (a “FDDEI transaction”) be in existence by the time the taxpayer files its return (including extensions) with respect to the FDDEI transaction (the “FDII filing date”). See §1.250(b)–3(f)(1). The final regulations do not impose additional requirements relating to when substantiating documents must be in existence. However, the timing of when substantiating documents are created may affect the credibility of the substantiating documents. For example, substantiating documents created at or near the time of the transaction generally have a higher degree of credibility as compared to substantiating documents created later in time. With respect to long-term contracts, substantiating documents created when the transaction was entered into will be more credible in later years if the taxpayer periodically confirms that the terms of the long-term contract are being adhered to.

The final regulations provide that substantiating documents must be provided to the IRS upon request, generally within 30 days or some other period agreed upon by the IRS and the taxpayer. See §1.250(b)–3(f)(1). This is necessary to allow the substantiation requirements to serve their purpose, including to allow the IRS to timely examine the taxpayer’s qualification for the FDII deduction.

D. Substantiation in All Other Cases

For the rules in the final regulations for which there are no specific substantiation requirements, taxpayers are already required under section 6001 to make returns, render statements, and keep the necessary records to show whether such person is liable for tax under the Code. Therefore, a taxpayer claiming a deduction under section 250 will still be required to substantiate that it is entitled to the deduction even if it is not subject to the specific substantiation requirements contained in the final regulations. See §1.6001–1(a); INDOPOC v. Commissioner, 503 U.S. 79, 84 (1992) (“an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer” (internal citations omitted)). The Treasury Department and the IRS expect that taxpayers may use a broader range of evidence to substantiate a section 250 deduction under the new substantiation requirements (and section 6001 where no specific substantiation requirements are provided) than they would have been able to use under the more specific documentation requirements detailed in the proposed regulations. Based on comments received, in many cases a taxpayer will be able to determine whether it meets the requirements in the final regulations using documents maintained in the ordinary course of its business, as provided in the transition rule. In some circumstances, however, it may be necessary for taxpayers to gather other forms of corroborative evidence.
additional information to establish that a requirement is met. The Treasury Department and the IRS are also considering issuing additional administrative guidance on acceptable documentation to substantiate the deduction.

E. Small Business Exception

The final regulations include an exception for small businesses similar to the exceptions from the documentation requirements for small businesses that are in the proposed regulations. See proposed §§ 1.250(b)–4(c)(2)(i)(A) and (d)(3)(ii)(A), and 1.250(b)–5(d)(3)(ii)(A) and (e)(3)(ii)(A). The exception provides that the substantiation requirements described generally in part II.B of this Summary of Comments and Explanation of Revisions section do not apply if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than $25,000,000 in gross receipts during the prior taxable year. See § 1.250(b)–3(f)(2). In response to comments that the final regulations should allow for broader application of the small business exception, the final regulations modify the threshold amount to qualify for that exception from $10,000,000 of gross receipts received by the seller of general property or renderer of services in the prior taxable year (the standard used in the proposed regulations) to $25,000,000 in gross receipts received by the taxpayer and all related parties. As a result of this exception, a small business will not need to satisfy the specific substantiation requirements in the regulations, although it must continue to comply with the general substantiation rules under section 6001. For example, small businesses may be able to substantiate that a sale of general property is for a foreign use by having evidence of a foreign shipping address and memorializing conversations with the recipients explaining where the property will be resold, if sufficiently reliable, or having a copy of an export bill of lading.

F. Transition Rules

The final regulations modify the applicability dates of the regulations to give taxpayers additional time to develop systems for complying with the regulations. Generally, the final regulations are applicable for taxable years beginning on or after January 1, 2021. See § 1.250–1(b). This applicability date ensures that all taxpayers, regardless of whether they are fiscal- or calendar-year taxpayers, have at least three full taxable years after the Act was enacted before the final regulations become applicable.

However, for taxable years beginning before January 1, 2021, taxpayers may apply the final regulations or rely on the proposed regulations, except that taxpayers that choose to rely on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019, which was the limitation contained in the proposed regulations).

III. Comments on and Revisions to Proposed § 1.250(a)–1—Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

Proposed § 1.250(a)–1 provided general rules to determine the amount of a taxpayer’s section 250 deduction and associated definitions that apply for purposes of the proposed regulations.

A. Pre-Act NOLs

Several Code sections, including section 250, include limitations based on a taxpayer’s taxable income or a percentage of taxable income. The proposed regulations provided an ordering rule for applying sections 163(j) and 172 in conjunction with section 250 that provided that a taxpayer’s taxable income for purposes of applying the taxable income limitation of section 250(a)(2) is determined after all of the corporation’s other deductions are taken into account, without distinguishing between pre-Act and post-Act net operating losses ("NOLs"). See proposed § 1.250(a)–1(c)(4).

Several comments noted that the proposed regulations did not explicitly address the impact of pre-Act NOLs on the deduction under section 250 and recommended that pre-Act NOLs not be taken into account for purposes of determining the deduction limit under section 250(a)(2). This would allow taxpayers to take a deduction under section 250 for FDII in lieu of utilizing available pre-Act NOLs.

Section 250(a)(2) limits the FDII deduction based on “taxable income,” which is defined in section 63 to include gross income minus deductions, including NOL deductions under section 172. Section 250(a)(2) contains no language that would support ignoring pre-Act NOLs for purposes of determining the amount of taxable income for purposes of section 250(a)(2). Cf. section 965(n) (providing an election to forgo usage of a portion of pre-Act NOLs against a taxpayer’s inclusion under section 965). Therefore, the comment is not adopted.

B. Ordering Rule

As discussed in the previous section, the deduction under section 250 is subject to a taxable income limitation under section 250(a)(2). Proposed § 1.250(a)–1(c)(4) provided that the corporation’s taxable income is determined with regard to all items of income, deduction, or loss, except for the deduction allowed under section 250. Example 2 in proposed § 1.250(a)–1(f)(2) applied the ordering rule with respect to sections 163(j), 172, and 250.

Some comments recommended that the regulations eliminate the ordering rule in favor of an approach that used simultaneous equations to compute taxable income for each Code provision that referred to taxable income, whereas other comments expressed concern with the complexity of performing simultaneous equations. One comment recommended that the regulations not consider section 163(j) and 172(b) carryforwards or carrybacks.

The Treasury Department and the IRS have determined that further study is required to determine the appropriate rule for coordinating section 250(a)(2), 163(j), 172, and other Code provisions (including, for example, sections 170(b)(2), 246(b), 613A(d), and 1503(d)) that limit the availability of deductions based, directly or indirectly, upon a taxpayer’s taxable income. Therefore, the final regulations remove Example 2 in proposed § 1.250(a)–1(f)(2) and reserve a paragraph in § 1.250(a)–1(c)(5)(ii) for coordinating section 250(a)(2) with other provisions calculated based on taxable income. The Treasury Department and the IRS are considering a separate guidance project to address the interaction of sections 163(j), 172, 250(a)(2), and other Code sections that refer to taxable income; this guidance may include an option to use simultaneous equations in lieu of an ordering rule.1 Comments are requested in this regard.

Before further guidance is issued regarding how allowed deductions are taken into account in determining the taxable income limitation in section 250(a)(2), taxpayers may choose any reasonable method (which could include the ordering rule described in the proposed regulations or the use of simultaneous equations) if the method

1 Any separate guidance would take into account the recent addition of section 172(a)(2)(B)(i)(I) by the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136, 134 Stat. 281 (2020). That provision provides in relevant part that, for taxable years beginning after December 31, 2020, the taxable income limitation for purposes of deducting net operating loss carrybacks and carryovers is determined without regard to the deductions under sections 172, 199A, and 250.
is applied consistently for all taxable years beginning on or after January 1, 2021.

C. Carryovers of Excess FDII

Consistent with the statute, the proposed regulations did not contain any provision allowing the carryforward or carryback of a tax year’s FDII deduction in excess of the taxpayer’s taxable income limitation under section 250(b)(2) and proposed § 1.250(a)–1(b)(2). One comment argued that a provision allowing the carryforward or carryback should be added because the taxable income limitation frustrates the policy goal of the FDII regime of reducing the tax incentive to locate intellectual property outside the United States. A different comment recommended that where the taxable income limitation of the proposed regulations applies to a given tax year, the final regulations should allow for the creation of a FDII recapture account by which taxpayers can carry forward previously unused section 250 deduction for future tax years when they have enough taxable income to use these deductions. In contrast, another comment recommended that, consistent with the statute, the final regulations should not allow for carrybacks or carryforwards in order to limit the potential for abuse by taxpayers.

The section 250 deduction is an annual calculation, and nothing in the statute or legislative history contemplates the creation of carryforwards or carrybacks or a recapture account. Cf. section 163(j)(2) (providing for the carryforward of disallowed business interest). As a result, the final regulations do not adopt these recommendations.

D. Definition of GILTI

The final regulations under section 250 revise the definition of GILTI consistent with the final regulations under section 951A (“section 951A final regulations”). The term “GILTI” means, with respect to a domestic corporation for a taxable year, the corporation’s GILTI inclusion amount under § 1.951A–1(c) for the taxable year. See § 1.250(a)–1(c)(3).

IV. Comments on and Revisions to Proposed § 1.250(b)–1—Computation of Foreign-Derived Intangible Income

The proposed regulations provided that a taxpayer’s FDII is the taxpayer’s deemed intangible income return (“DTIR”). See proposed § 1.250(b)–1(c)(3). A taxpayer’s DTIR is 10 percent of the taxpayer’s qualified business asset investment (“QBAI”). See proposed § 1.250(b)–1(c)(4). The foreign-derived ratio is the taxpayer’s ratio of foreign-derived deduction eligible income (“FDDEI”) to DEI. See proposed § 1.250(b)–1(c)(13).

A. Financial Services Income

Section 250(b)(3)(A)(ii)(III) excludes from DEI financial services income as defined in section 904(d)(2)(D). One comment requested a clarification that income that falls outside of the definition of section 904(d)(2)(D) should be eligible for inclusion in DEI, such as leasing or financing activities outside of the active conduct of a banking, financing, or similar business.

Section 250(b)(3)(A)(ii)(III) excludes only financial services income as defined in section 904(d)(2)(D). Any leasing or financing activities that are not described in section 904(d)(2)(D) will not fall within this exclusion. Therefore, no changes are necessary.

Another comment suggested that the proposed regulations do not provide enough general guidance on non-active financial services income from financial instruments (such as derivatives and hedges), and, in particular, how to characterize such income (or losses) as a FDDEI transaction. Absent such guidance, the comment asserts that taxpayers could take inconsistent positions in characterizing a derivative or hedge and characterizing the underlying transaction as FDDEI transactions. This comment recommended adding a general rule that associates the income, loss, and expenses of a derivative or hedge with the underlying transaction. Alternatively, the comment suggested that the final regulations treat the derivative or hedge transaction as a separate transaction and test it for FDDEI under the rules regarding sales of intangible property.

Consistent with the proposed regulations, the final regulations provide that, in general, financial instruments are neither general property nor intangible property, and therefore their sales cannot give rise to FDDEI. See § 1.250(b)–3(b)(10) (excluding from the definition of general property a security defined under section 475(c)(2)(J) and § 1.250(b)–3(b)(11) (intangible property has the meaning set forth in section 367(d)(4)). However, the final regulations adopt the suggestion to provide a general rule for hedges to associate the income or loss from such hedges with the underlying transaction.

See § 1.250(b)–4(f) and part VII.E of this Summary of Comments and Explanation of Revisions section.

B. Definition of Foreign Branch Income

Section 250(b)(3) excludes from DEI foreign branch income as defined in section 904(d)(2)(J), which provides that foreign branch income is business profits attributable to one or more qualified business units. Proposed § 1.250(b)–1(c)(11) defined foreign branch income by cross-reference to § 1.904–4(f)(2), which provides that gross income is attributable to a foreign branch if the gross income is reflected on the separate set of books and records of the foreign branch. Proposed § 1.250(b)–1(c)(11), however, modified this definition to also include any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest.

Several comments requested that the final regulations remove the modification to the definition in proposed § 1.904–4(f)(2). Several comments noted that the definition, as proposed, would impermissibly create a class of income that is neither DEI nor foreign branch income for section 904 foreign tax credit purposes, and therefore, asserted that the definitions must be aligned consistently. Another comment argued that the proposed regulations under section 904 already contain rules that address the types of transactions that were described in proposed § 1.250(b)–1(c)(11). Multiple comments also noted that section 250(b)(3)(A)(ii)(VI) cross references to section 904(d)(2)(J) without any modification to that latter provision and argued that modifying the definition in regulations exceeded the Treasury Department and IRS’s regulatory authority. One comment argued that the expansion contravenes the Congressional purpose behind FDII of encouraging the repatriation of intangible property. Another comment noted that if the definition with the modification is applied retroactively, it could adversely affect taxpayers that undertook transactions to repatriate intellectual property before the proposed regulations were issued, a problem that the comment asserted is exacerbated by the differing effective dates of the proposed foreign tax credit regulations and the FDII proposed regulations.

If the final regulations were to retain the expanded definition, one comment requested that the definition also be
used for purposes of the foreign branch category definition in § 1.904–4(f).
Another comment requested that the final regulations provide further clarification of the treatment of the disregarded transactions, particularly with respect to the disposition of a partnership interest, and provide relevant examples of other types of transactions that the expanded definition is intended to capture.
Moreover, the comment requested that the definition of foreign branch income should be modified such that it would not include any adjustments that would increase the gross income attributable to the foreign branch as a result of the transfer of intangible property from the foreign branch to the foreign branch owner.
The Treasury Department and the IRS agree that there should be one consistent definition of foreign branch income in both §§ 1.250(b)–1(c)(11) and 1.904–4(f)(2) to avoid the various results suggested by comments. Accordingly, the final regulations define foreign branch income by cross reference to § 1.904–4(f)(2) and remove the modification to that definition in the proposed regulations that would have included as foreign branch income any income from the sale, directly or indirectly, of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. See § 1.250(b)–1(c)(11).2

C. Cost of Goods Sold Allocation

The proposed regulations provided that for purposes of determining the gross income included in gross DEI and gross FDDEI, cost of goods sold is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method. See proposed § 1.250(b)–1(d)(1). The final regulations clarify that the method chosen by the taxpayer must be consistently applied.
For purposes of this rule, any cost of goods sold associated with activities undertaken in an earlier taxable year cannot be segregated into component costs and attributed disproportionately to amounts excluded from gross FDDEI or to amounts excluded from gross DEI, similar to the rules in proposed § 1.199–4(b)(2)(iii)(A). The preamble to the proposed regulations requested comments on whether there are alternative approaches for dealing with timing issues, and whether additional rules should be provided for attributing cost of goods sold in determining gross DEI and gross FDDEI.
One comment recommended that the final regulations continue to allow cost of goods sold to be allocated under any reasonable method to provide flexibility to different taxpayers. Another comment agreed with the proposed regulations that cost of goods sold should be allocated between gross FDDEI and gross non-FDDEI regardless of whether any component of the costs was associated with activities undertaken in a prior tax year. That comment, however, recommended that for future periods taxpayers that recognized revenue under section 451 for advance payments should be permitted an election to create an imputed cost of goods sold deduction based upon the taxpayer’s gross profit percentage for that particular product or service. The comment argued this election is needed because recognition of an advance payment as income without associated cost of goods sold might be required under section 451 based upon certain facts and circumstances and the election would allow the taxpayer to avoid this distorting impact.
Sections 451 and 461 provide the general rules on the timing of income recognition and taking a deduction into account, respectively. Nothing in section 250 suggests that Congress intended to change the scope of generally applicable income recognition rules. Therefore, the final regulations do not adopt the comment to permit an election to create an imputed cost of goods sold deduction in the context of advance payments with respect to section 250.

D. Expense Allocation

1. In General

In determining DEI under section 250(b)(3), a taxpayer must determine the deductions that are “properly allocable” to gross DEI. Proposed § 1.250(b)–1(d)(2)(i) further provided that, for purposes of calculating FDDEI, a taxpayer must determine the deductions that are “properly allocable” to gross FDDEI. Consistent with the rules for determining the foreign tax credit limitation under section 904 or qualified production activities income under former section 199, the proposed regulations provided that §§ 1.861–8 through 1.861–14T and 1.861–17 apply for purposes of allocating deductions to gross DEI and gross FDDEI. Id. Several comments supported using these general apportionment rules.

2. Research and Experimentation Expenditures

Under § 1.861–17(b), an exclusive apportionment of research and experimentation (“R&E”) expenditures is made if activities representing more than 50 percent of the R&E expenditures were performed in a particular geographic location, such as the United States. After this initial exclusive apportionment, the remainder of the taxpayer’s R&E expenditures are apportioned under either the sales or gross income methods under § 1.861–17(c) and (d). Section 1.861–17(e) provides rules for making a binding election to use either the sales or gross income method.

a. Exclusive Apportionment and Direct Apportionment

The proposed regulations under section 250 specified that the exclusive apportionment rules in § 1.861–17(b) did not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI. See proposed § 1.250(b)–1(d)(2)(i). Several comments requested that the final regulations allow taxpayers to use exclusive apportionment for purposes of determining FDII. One comment noted that the preamble to the proposed regulations does not justify the proposed regulations omitting the exclusive apportionment method in the FDII context. Another comment asserted that allowing exclusive apportionment would mitigate a significant disincentive for taxpayers to onshore intangible property into the United States. Other comments argued that allocating R&E expenses to FDDEI may discourage taxpayers from performing R&E activities in the United States.
Several comments recommended allocating R&E expenditures based on an optional books and records method that could be used when there is a clear factual relationship between the R&E expenditures and a particular amount of income. These comments noted that some taxpayers are subject to regulatory oversight with respect to their contract pricing and costs, and therefore such taxpayers’ books and records could be an accurate way of showing the relationship between R&E expenses and gross income.
Several comments also requested that the final regulations adopt special rules for expenses that are not subject to restricted or market-required (for example, expenses required only by the U.S. Food
and Drug Administration concerning the U.S. market), including where the legally mandated rule in § 1.861–17(a)(4) would not apply. One comment noted that this rule could apply in situations where U.S. law limits the realization from certain research activities to the market in which the research is performed (such as export controls) and therefore the R&E expenditures would not be expected to generate gross income outside the United States.

Several comments requested that if none of these recommendations for allocating R&E expenses are adopted, the final regulations should reserve on this provision pending the broader ongoing review of § 1.861–17 by the Treasury Department.

In light of the issuance of proposed rules under § 1.861–17 on December 17, 2019 (84 FR 69124) (the “2019 FTC proposed regulations”), the final regulations remove the provision stating that the exclusive apportionment rules in § 1.861–17(b) do not apply for purposes of apportioning R&E expenses to gross DEI and gross FDDEI, and generally do not provide special rules for applying § 1.861–17 for purposes of section 250. Proposed § 1.861–17 in the 2019 FTC proposed regulations provides that the exclusive apportionment rule applies only to section 904 as the operative section, and also proposes eliminating the special rule for legally mandated R&E. As recommended by comments to the proposed regulations under section 250, the Treasury Department and the IRS will consider the issues raised regarding the application of exclusive apportionment for purposes of section 250 as part of finalizing the 2019 FTC proposed regulations.

b. Use of Sales or Gross Income Method

Several comments requested that the final regulations include an election to allocate R&E expenses under either the sales or gross income method. Comments also requested that taxpayers should be permitted to make this election annually to give taxpayers a longer period to assess the various new regimes that rely on § 1.861–17 such as section 250, and pending the finalization of the FDII regulations. Another comment suggested that the final regulations should provide that the provisions of § 1.861–17(c)(3) (requiring sales to third parties by controlled foreign affiliates to be included) should not apply as it might artificially apportion more R&E expense against FDII.

As described in the preamble to proposed § 1.861–17 in the 2019 FTC proposed regulations, the Treasury Department and the IRS are concerned that the gross income method could in some cases produce inappropriate results. See 84 FR 69124. As a result, the 2019 FTC proposed regulations proposed to eliminate the optional gross income method described in § 1.861–17(d) and require R&E expenditures in excess of the amount exclusively apportioned under § 1.861–17(b) to be apportioned based on gross receipts. See proposed § 1.861–17(d).

Comments addressing the applicability of the gross income method will be addressed as part of finalizing the 2019 FTC proposed regulations.

Proposed § 1.861–17(e)(3), published December 7, 2018 (83 FR 63200), permitted taxpayers a one-time exception to what would otherwise be a five-year binding election period under § 1.861–17(e)(1) to use either the sales or the gross income method, in light of the many changes to the foreign tax credit rules made by the Act. Under proposed § 1.861–17(e)(3), even if a taxpayer is subject to the binding election period, for the taxpayer’s first taxable year beginning after December 31, 2017, the taxpayer may change its apportionment method without obtaining the Commissioner’s consent. Comments to the proposed regulations under section 250 requested that this one-time exception be extended to at least a second tax year beginning after December 31, 2017, potentially at the election of the taxpayer, pending the Treasury Department’s ongoing review of § 1.861–17 regulations issued under § 1.861–17 on December 17, 2019, provide an additional year for taxpayers to change their election of the sales or gross income method. See § 1.861–17(e)(3).

3. Carryovers

Comments requested additional clarification regarding whether taxpayers are required to apportion expenses incurred before the effective date of the proposed regulations. Multiple comments specifically asked for a clarification that taxpayers are not required to apportion NOLs incurred before the effective date of the proposed regulations or, in some cases, before the effective date of the Act, recommending that a clarification could be along the lines of § 1.199–4(c)(2)(i) (providing that a deduction under section 172 for a net operating loss is not allocated or apportioned to domestic production gross receipts or gross income attributable to domestic production gross receipts).

The final regulations address this comment by providing that the following provisions (which limit certain deductions and provide for the carryover of the amounts not currently allowed) do not apply when allocating and apportioning deductions to gross DEI or gross FDDEI of a taxpayer for a taxable year: Sections 163(j), 170(b)(2), 172, 246(b), and 250. See § 1.250(b)–1(d)(2)(ii). The Treasury Department and the IRS considered a rule that would require expenses incurred in prior years, including in years before the effective date of the proposed regulations, to be allocated to gross DEI and gross FDDEI, but determined that the benefit of the theoretical precision of this approach would be outweighed by the burden on taxpayers and the IRS that would be associated with making retroactive determinations. Further, the approach taken in the final regulations is consistent with the premise that section 250 deduction is calculated based on annual income and expenses.

E. Foreign-Derived Ratio

The proposed regulations provided rules for determining a taxpayer’s foreign-derived ratio, which is the ratio of FDDEI to DEI. See proposed § 1.250(b)–1(c)(13). The preamble to the proposed regulations observed that as a result of expense apportionment or attribution of cost of goods sold to gross receipts, a taxpayer’s FDDEI could exceed its DEI, thereby resulting in a foreign-derived ratio greater than one. The preamble noted that this result would be inconsistent with section 250(b)(4), which defines FDDEI as a subset of DEI, as it would lead to having FDII in excess of DI. Therefore, the proposed regulations clarified that the foreign-derived ratio cannot exceed one.

Several comments requested that the final regulations allow the foreign-derived ratio to exceed one. The comments asserted that the foreign-derived ratio can in fact exceed one under the statute where the taxpayer has losses that cause its FDDEI to exceed its DEI, and that there is no evidence Congress intended to limit the foreign-derived ratio to no greater than one. One of the comments asserted that FDDEI and DEI are defined by the statute and that the Treasury Department and the IRS do not have the authority to define FDDEI more narrowly than the statute does. Another comment argued that section 250(a)(2) provides a separate taxable income limitation that limits the FDII deduction based on domestic losses. This comment further asserted that the foreign-derived ratio rule of the proposed regulations reduces a taxpayer’s incentive for patriating intangible property when the foreign income from these intangibles cannot be
used to offset domestic losses for purposes of applying section 250.

One comment further suggested that the final regulations allow a taxpayer to elect to determine its FDII deduction, including the various elements of the determination such as DII, QBAI, and DTIR, based on specific product lines or business lines, as determined by the taxpayer. The comment asserted that such an approach would be analogous to other provisions that calculate taxable income separately for different subsets of income such as former section 199, the foreign tax credit limitation under section 904(d), separate limitation loss recapture rules in sections 904(f) and (g), and §§ 1.994–1(c) and 1.994–2(b). The comment argued that such an approach to determining FDII is more consistent with the policy goal of reducing the tax incentive to locate intellectual property outside the United States, which the comment asserted would be frustrated if domestic losses reduce FDII-eligible income.

The Treasury Department and the IRS do not agree that limiting the foreign-derived ratio to no greater than one is inconsistent with the plain meaning of section 250. Specifically, the approach recommended by the comments would be inconsistent with the statutory language of section 250(b)(4), which defines FDDEI as a subset of DEI, and (g), and §§ 1.994–1(c) and 1.994–2(b). The comment asserted that such an approach would be analogous to other provisions that calculate taxable income separately for different subsets of income such as former section 199, the foreign tax credit limitation under section 904(d), separate limitation loss recapture rules in sections 904(f) and (g), and §§ 1.994–1(c) and 1.994–2(b). The comment argued that such an approach to determining FDII is more consistent with the policy goal of reducing the tax incentive to locate intellectual property outside the United States, which the comment asserted would be frustrated if domestic losses reduce FDII-eligible income.

The final regulations do not include a more limited reporting requirement because the Treasury Department and IRS are concerned that this might undermine accurate reporting at the partner level. In addition, the Treasury Department and IRS disagree with the comment’s observation that reporting by the partnership of items under section 250 could only reduce a partner’s tax liability. The comment further requested the addition of a reasonable cause exception (consistent with the penalty defenses available for the Form 8865 penalties).

The final regulations do not include a more limited reporting requirement because the Treasury Department and IRS are concerned that this might undermine accurate reporting at the partner level. In addition, the Treasury Department and IRS disagree with the comment’s observation that reporting by the partnership of items under section 250 could only reduce a partner’s tax liability. The comment further requested the addition of a reasonable cause exception (consistent with the penalty defenses available for the Form 8865 penalties).

The section 951A final regulations provided certain revisions and clarifications to the proposed regulations under that section (“section 951A proposed regulations”). See § 1.951A–3. The preamble to the section 951A final regulations noted that, except as indicated with respect to the election to use a depreciation method other than the alternative depreciation system (“ADS”) for determining the adjusted basis in specified tangible property for assets placed in service before the enactment of section 951A (See part V.B of this Summary of Comments and Explanation of Revisions section), modifications similar to the revisions to proposed § 1.951A–3 will be made to proposed § 1.250(b)–2. These modifications generally clarify the QBAI computation with respect to dual-use property (§ 1.250(b)–2(d)) and partnerships (§ 1.250(b)–2(g)). Accordingly, the final regulations make conforming changes to QBAI for purposes of FDII similar to the changes made to proposed § 1.951A–3 in the section 951A final regulations. See § 1.250(b)–2(2).

B. Determination of Basis Under ADS

The proposed regulations provided that, for purposes of determining QBAI, the adjusted basis in specified tangible
property is determined by using ADS under section 168(g), and by allocating the depreciation deduction with respect to such property for the taxpayer’s taxable year ratably to each day during the period in the taxable year to which such depreciation relates. See section 951A(d)(3) and proposed § 1.250(b)–2(e)(1). ADS applies to determine the adjusted basis in property for purposes of determining QBAI regardless of whether the property was placed in service before the enactment of section 250 or section 951A, or whether the basis by reference, section 250(b)(2)(B)) is clear that the adjusted basis in specified tangible property is determined using ADS under section 168(g). In addition, permitting taxpayers to elect to follow U.S. GAAP in the context of FDII will impose significant administrative burdens on the IRS to determine what would be immaterial and account for different depreciation methods to compute QBAI.

C. QBAI Anti-Avoidance Rule

In order to prevent artificial decreases to the DTIR amount, the proposed regulations disregarded certain transfers of specified tangible property by a domestic corporation to a related party where the corporation continues to use the property in production of gross DEI. In particular, proposed § 1.250(b)–2(h)(1) disregarded a transfer of specified tangible property by the taxpayer to a related party if, within a two-year period beginning one year before the transfer, the taxpayer leases the same or substantially similar property from a related party and such transfer and lease occur with a principal purpose of reducing the taxpayer’s DTIR. In addition, a transfer or leaseback transaction was treated as per se undertaken for a principal purpose of reducing the transferor’s DTIR if the transfer and leaseback each occur within a six-month span. See proposed § 1.250(b)–2(h)(3).

Comments recommended that the final regulations contain a transition period for the QBAI anti-avoidance rule in proposed § 1.250(b)–2(h)(3) for transactions entered into before the date that the proposed regulations were issued. The final regulations adopt this comment. See § 1.250(b)–2(h)(5).

Another comment recommended that a taxpayer be able to rebut the presumption that a transfer or leaseback transaction was undertaken for a principal purpose of reducing the transferor’s DTIR if the transfer and leaseback each occurred within a six-month span. The final regulations do not adopt this recommendation because a transfer and lease of the same or similar property that occurs between related parties within six months does not materially change the economic risk of the parties and is unlikely to be motivated by non-tax reasons. In addition, permitting taxpayers to rebut the presumption that such a transaction was undertaken for a principal purpose of reducing the transferor's DTIR creates significant administrative burdens.

VI. Comments on and Revisions to Proposed § 1.250(b)–3—FDDEI Transactions

The proposed regulations provided that FDDEI is the excess of gross FDDEI over deductions properly allocable to gross FDDEI. See proposed § 1.250(b)–1(c)(12). The proposed regulations defined gross FDDEI as the portion of a corporation’s gross DEI that is derived from all of its “FDDEI sales” and “FDDEI services.” See proposed § 1.250(b)–1(c)(15). The proposed regulations defined “sale” to include a lease, license, exchange, or other disposition of property, including a transfer of property resulting in gain or an income inclusion under section 367. See proposed § 1.250(b)–3(b)(7).

A. Definition of “General Property”

1. Treatment of Commodities

For purposes of determining what is a FDDEI sale (and relatedly, whether a sale is for a foreign use), the proposed regulations distinguished between “general property” and certain other types of property. The proposed regulations excluded any commodity (as defined in section 475(e)(2)(B) through (D)) from the definition of general property. See proposed § 1.250(b)–3(b)(3). The proposed regulations did not exclude from the definition of general property a commodity described in section 475(e)(2)(A), and therefore, the sale of such a commodity may qualify as a FDDEI sale. A comment raised a concern that the sale of a physical commodity effected through certain derivative contracts (described in section 475(e)(2)(B) through (D)) might not be treated as a sale of general property under the proposed regulations. The comment recommended clarifying that the sale of a physical commodity in satisfaction of a forward contract is not excluded from the definition of general property.

The Treasury Department and the IRS generally agree that a sale of a commodity such as an agricultural commodity or a natural resource should be a sale of general property whether it is sold pursuant to a spot contract or sold pursuant to a forward or option contract, other than a section 1256 contract or similar contract that is traded and cleared like a section 1256 contract. The sale of such a commodity through a futures or option contract that is a section 1256 contract or similar contract is not treated as a sale of general property because the interposition of a clearing organization as the counterparty to such contracts severs the connection between the original selling and buying parties to the contract such that no meaningful determination can be made whether the sale or futures or option contract is for a foreign use. The definition of “general property” in § 1.250(b)–3(b)(10) is modified accordingly. The final regulations also clarify that financial instruments or similar assets traded through futures or similar contracts do not qualify as general property.

The Treasury Department and the IRS are concerned, however, that a taxpayer could manipulate its FDDEI by selectively physically settling only its commodities forward or option contracts in which it has a gain. To prevent this manipulation, the final regulations provide that the sale of a commodity pursuant to a forward or option contract is treated as a sale of general property only to the extent that a taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances. See § 1.250(b)–3(b)(10).

The proposed regulations further provided that a sale of a security (as defined in section 475(c)(2)) or a commodity (as defined in section 475(e)(2)(B) through (D)) is not a FDDEI sale. See proposed § 1.250(b)–4(f). This rule is no longer necessary because the final regulations exclude such property from the definition of general property.
2. Treatment of Interests in Partnerships

The proposed regulations did not address the conditions under which the sale of a partnership interest that is not described in section 475(c)(2)(A) and therefore not general property under § 1.250(b)–3(b)(10), interests in a partnership are not the type of property that can be subject to “any use, consumption, or disposition” outside the United States. Furthermore, a look-through approach would be inconsistent with the fact that title to the partnership’s property does not change upon the sale of an interest in a partnership and also would be difficult to administer given that the underlying property that would be tested for foreign use is not actually being transferred. Accordingly, the final regulations provide that an interest in a partnership, as well as an interest in a trust or estate, is not general property. See § 1.250(b)–3(b)(10).

3. Exclusion of Intangible Property

Under the proposed regulations, the rules applicable to the determination of whether a sale of property is for a foreign use depend on whether the sale is of “general property” or “intangible property.” See proposed § 1.250(b)–4(e)(4)(i)(D) and (E) (Example 4 and 5). One comment recommended that if the distinction between sales of tangible and intangible property is maintained, then the final regulations should provide that software transactions involving the sale or lease of copyrighted articles are governed by the general property rules and not the intangible property rules.

The final regulations make several changes in response to this comment. Consistent with the request in the comment, the definition of “intangible property” for purposes of section 250 is clarified to not include a copyrighted article as defined in § 1.861–18(c)(3). See § 1.250(b)–3(b)(11). However, the rules for determining foreign use that apply to general property are not suitable for sales of digital content, including copyrighted articles, that are transferred electronically, because those rules focus on the physical transfer of property to end users. Therefore, the final regulations provide an additional rule for sales of general property that primarily contain digital content. See § 1.250(b)–4(d)(1)(i)(D). Under the final regulations, “digital content” is defined as a computer program or any other content in digital format. See § 1.250(b)–3(b)(1). The determination of how a transfer of a copyrighted article is characterized (for example, as a sale or a service) for purposes of applying the final regulations is based on general U.S. tax principles, taking into account the regulations issued under section 861.5

Notwithstanding the final regulations’ treatment of sales of copyrighted articles for purposes of determining foreign use, no inference is intended with respect to the treatment of sales of copyrighted articles under other sections of the Code. For example, the fact that a sale of a copyrighted article (or other property) is treated as a FDDEI sale does not necessarily mean that the income from the sale is foreign source under section 861.

B. Foreign Military Sales and Services

The proposed regulations provided that for purposes of section 250 a sale of property or a provision of service to the U.S. government that is governed by the Arms Export Control Act of 1976, as amended (22 U.S.C. 2751 et. seq.), is treated as a sale of property or provision of a service to a foreign government, and therefore may qualify as a FDDEI transaction if the other requirements under proposed §§ 1.250(b)–3 through 1.250(b)–6 are satisfied. See proposed § 1.250(b)–3(c). The proposed regulations requested comments on identifying readily available documentation sufficient to demonstrate that a particular sale or service was made pursuant to the Arms Export Control Act.

Several comments requested removal of the requirement in proposed § 1.250(b)–3(c) that the resale or on-service to a foreign government or agency or instrumentality thereof must be “on commercial terms.” The comments asserted that this requirement was ambiguous and observed that the taxpayer would not necessarily have access to the contract between the U.S. government and the foreign counterparty and therefore could not necessarily evaluate the commerciality of such contract. The comments also objected to the requirement that the contract between the taxpayer and the U.S. government specifically refer to the resale or on-service to the foreign government, stating that the contract may not always specify this information but that the resale or on-service could be evidenced by the taxpayer’s generally available records.

In response to the preamble’s request for comments on suitable documentation to demonstrate that a foreign military sale qualifies under this special rule, several comments noted that no one particular document will suffice to demonstrate that a given sale or service qualifies. Nevertheless, comments stated that ordinary course documentation should suffice to show that the sale or service qualifies. If the final regulations were to retain a list of particular documents required to demonstrate that a particular sale or service was made pursuant to the Arms Export Control Act, the comments suggested various types of documents that might be available but also stated that any list of these documents should be non-exclusive since any one document may not exist for a particular sale or service. And, in any event, the Department of Defense and the State Department modify their forms frequently. One comment asked for transitional relief for any pre-existing contracts, if the final regulations were to provide an exclusive list of required documentation. Another comment requested a presumption of foreign use in the context of foreign military sales based on the high likelihood that defense articles would satisfy foreign use—sales made pursuant to the Arms Export Control Act are limited to foreign strategic partners who intend to use
articles in a certain manner, such as, self-defense and internal security—and the low likelihood that a foreign person could use a defense article within the United States.

In general, the final regulations adopt the comments. Section 1.250(b)–3(c) does not include a requirement that the foreign military sale or service be “on commercial terms” or that the contract specifically refer to the resale or on-service to the foreign government. Instead, if a sale of property or a provision of a service is made pursuant to the Arms Export Control Act, then the sale of property or provision of a service is treated as a FDDEI sale or FDDEI service without needing to apply the general rules in §1.250(b)–4 or §1.250(b)–5. See §1.250(b)–3(c). The final regulations also do not require any particular documentation to substantiate that a transaction qualifies under the rule in §1.250(b)–3(c). Taxpayers will continue to be required to substantiate under section 6001 that any foreign military sale or service qualifies for a section 250 deduction.

C. Reliability of Documentation and Reason To Know Standard

The proposed regulations provided that to establish that a recipient is a foreign person, property is for a foreign use, or a recipient of a general service is located outside the United States, the taxpayer must obtain specific types of documentation described in proposed §§1.250(b)–4(c)(2), (d)(3), and (e)(3) and 1.250(b)–5(d)(3) and (e)(3). The proposed regulations also provided that the seller or renderer must not know or have reason to know that the documentation is incorrect or unreliable. Proposed §1.250(b)–3(d)(1). One comment requested that the final regulations provide more guidance and relevant examples regarding the scope of this rule, in particular what knowledge should be imputed across a large organization and how the standard should apply when relevant information is legally protected by data privacy laws.

As described in part II of this Summary of Comments and Explanation of Revisions section, the final regulations replace the documentation requirements with substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used. The knowledge or reason to know standard is retained in §§1.250(b)–3(f)(3) (treatment of certain loss transactions), 1.250(b)–4(c)(1) (foreign person requirement), (d)(1)(ii)(C) (general property incorporated into a product as a component) and (d)(2)(ii)(C)(2) (sale of intangible property consisting of a manufacturing method or process to a foreign unrelated party), and 1.250(b)–5(d)(1) (general services provided to consumers). In response to comments, the final regulations provide additional detail regarding the application of the reason to know standard in these sections. The final regulations generally provide that a taxpayer has reason to know that a transaction fails to satisfy a substantive requirement if the information that the taxpayer receives as part of the sales process contains information that indicates that the substantive requirement is not met and, after making reasonable efforts, the taxpayer cannot establish that the substantive requirement is met. See §§1.250(b)–3(f)(3), 1.250(b)–4(c)(1), (d)(1)(ii)(C) and (d)(2)(ii)(C)(2), and §1.250(b)–5(d)(1).

D. Sales or Services to a Partnership

For purposes of determining a taxpayer’s FDII attributable to sales of property or services to a partnership, the proposed regulations adopted an entity approach to partnerships. See proposed §1.250(b)–3(g)(1). One comment suggested that if a seller of a good has a greater than 10 percent ownership interest in the recipient domestic partnership, the final regulations should also permit aggregate treatment of the partnership for this limited purpose. The comment observed that the proposed regulations do not permit sales to a domestic partnership to qualify as a FDDEI sale because a domestic partnership is not a foreign person under proposed §1.250(b)–3(b)(2). According to the comment, in certain industries, customers request “teaming arrangements” that require bidders to form a single domestic bidding entity that will govern the relationship between the members of the team, but most of the work is performed by the partners, under subcontract from the partnership. The comment recommended that the practice of joint bidding should not disqualify the activity for FDII purposes. With respect to a taxpayer’s sales of property to a partnership, one comment suggested that the final regulations consider alternatives to a pure entity approach. The comment outlined two other approaches to determine if a sale to a partnership qualifies as a FDDEI sale based on whether the partnership is predominantly engaged in foreign business or a pure aggregate approach to treat the partnership as a foreign person to the extent of its ownership by direct or indirect owners. With respect to a partnership engaged in multiple lines of business, each business could be viewed as a separate person for FDII purposes. While the comment did not support an aggregate approach or advocate a specific approach, the comment noted that the Treasury Department and the IRS should balance legislative intent, administrative burden, and precision.

The final regulations do not adopt these comments. The statute is clear that in the case of sales of property, the sale must be to a person that is not a United States person, and a domestic partnership is a United States person. See part VII.B of this Summary of Comments and Explanation of Revisions section. In addition, requiring taxpayers to trace the ownership, potentially through multiple tiers, of third-party partnership recipients presents significant administrative hurdles. If, alternatively, this regime were elective, it would create the potential for abuse or uneven results for similarly situated taxpayers.

E. Treatment of Certain Loss Transactions

The proposed regulations provided that if a seller or renderer knows or has reason to know that property is sold to a foreign person for a foreign use or a general service is provided to a person located outside the United States, but the seller or renderer does not satisfy the documentation requirements applicable to such sale or service, the sale of property or provision of a service is nonetheless deemed a FDDEI transaction if treating the sale or service as a FDDEI transaction would reduce a taxpayer’s FDDEI. See proposed §1.250(b)–3(f). One comment requested a clarification that taking the FDII deduction should be considered an elective action and that this rule does not impact such an election.

As described in part II of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations adopt a more flexible approach to the FDII-specific documentation rules and instead provide specific substantiation requirements for certain elements of the regulations. Accordingly, the rule with respect to loss transactions is revised so that it only applies to transactions for which there is a specific substantiation requirement. See §1.250(b)–3(f)(3)(ii). However, the fact that §1.250(b)–3(f)(3) has been narrowed in the final regulations does not mean that the allowed FDII deduction can be determined on a transaction-by-transaction basis. As explained in the final regulations, FDII is determined on a single aggregate basis, not on a
transaction-by-transaction basis. See § 1.250(b)–1.

The final regulations also clarify that for purposes of the loss transaction rule, whether a taxpayer has reason to know that a sale of property is to a foreign person for a foreign use, or that a general service is provided to a business recipient located outside the United States, depends on the information received as part of the sales process. If the information received as part of the sales process contains information that indicates that a sale is to a foreign person for a foreign use or that a general service is to a business recipient located outside the United States, the requisite reason to know is present unless the taxpayer can prove otherwise. See § 1.250(b)–3(f)(3)(ii). With respect to sales, the final regulations provide a non-exhaustive list of information that indicates that a recipient is a foreign person or that the sale is for a foreign use, such as a foreign address or phone number. While not all sales to a foreign person are for a foreign use (nor are all sales for a foreign use made to foreign persons), the final regulations use the same indicia for both requirements because a foreign person is more likely to make a purchase for a foreign use compared to a U.S. person. With respect to general services, information that indicates that a recipient is a business recipient include indicia of a business status, such as “LLC” or “Company,” or similar indicia under applicable law, in its name. Information that indicates that a business recipient is located outside the United States includes, but is not limited to, a foreign phone number, billing address, and evidence that the business was formed or is managed outside the United States. These rules can also apply in the case of sales made by related parties where the foreign related party is treated as the seller and the unrelated party transaction is being analyzed. See § 1.250(b)–6(c)(2).

The final regulations do not include a rule specifying that a taxpayer may choose not to claim a FDII deduction. Whether an allowable deduction must be claimed by general tax principles and rules on whether such deduction can be elective is beyond the scope of these regulations.

F. Predominant Character Rule

The proposed regulations provided that if a transaction includes both a sale component and a service component, the transaction is classified according to the overall predominant character of the transaction for purposes of determining whether the transaction is subject to the FDDEI sales rules of proposed § 1.250(b)–4 or the FDDEI services rules of proposed § 1.250(b)–5. See proposed § 1.250(b)–3(e). A comment expressed support for the predominant character rule for transactions that contain both sale and service components in general but also suggested that the final regulations allow taxpayers to elect to follow U.S. GAAP accounting, which may in certain circumstances require the disaggregation of the sale and service components of a single transaction.

For purposes of simplicity and to avoid the need for complex apportionment rules, § 1.250(b)–3(d) provides a rule to determine the predominant character of the transaction when a transaction has multiple elements, such as a sale of general property and a service or sale of general property and sale of intangible property. The Treasury Department and the IRS have determined that an elective rule that allows for disaggregation would create significant complexity for taxpayers and be difficult for the IRS to administer, and could lead to whipsaw for the IRS as taxpayers elect to disaggregate when it increases the FDII deduction but not otherwise.

Accordingly, the final regulations do not adopt the comment to include an election to follow U.S. GAAP to disaggregate a single transaction.

VII. Comments on and Revisions to Proposed § 1.250(b)–4—FDDEI Sales

Section 250(b)(4)(A) provides that FDDEI includes income from property the taxpayer sells to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use. Accordingly, the proposed regulations defined a FDDEI sale as a sale of property to a foreign person for a foreign use. See proposed § 1.250(b)–4(b).

A. End User Requirement

The proposed regulations provided that a sale of intangible property is for a foreign use to the extent the intangible property generates revenue from exploitation outside the United States, which is generally determined based on the location of end users purchasing products for which the intangible property was used in development, manufacture, sale, or distribution. See proposed § 1.250(b)–4(e)(2)(i). Several comments requested that the final regulations clarify the definition of an “end user.” One comment recommended that an “end user” be defined as any consumer or business recipient that purchases a finished good for its own use or consumption (not for resale or further manufacture, assembly, or other processing). Another recommended that the finished good manufacturer or original equipment manufacturer, rather than the ultimate customer of the manufacturer, be treated as the end user.

The final regulations generally adopt the comment that the end user should be the consumer that purchases the property for its own consumption. See § 1.250(b)–3(b)(2). Further, as discussed in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, the concept of an end user is also incorporated into the rules for determining whether a sale of general property, in addition to intangible property, is for a foreign use. See § 1.250–4(d). In this way, to the extent possible, the final regulations harmonize the rules for sales of general property and intangible property.

Section 1.250(b)–3(b)(2) defines the “end user” as the person that ultimately uses the property, and that a person who acquires property for resale or otherwise as an intermediary is not an end user. The definition of end user is modified for intangible property used in connection with the sale of general property, provision of services, sale of a manufacturing method or process intangible property, and for research and development as provided in § 1.250(b)–4(d)(2)(ii).

The final regulations do not adopt the comments that in all cases a finished goods manufacturer may be an end user. However, as described in part VII.C.7 of this Summary of Comments and Explanation of Revisions section, the final regulations continue to provide that sales of general property for manufacturing, assembly, or other processing outside the United States are sales for a foreign use. See § 1.250(b)–4(d)(1)(iii). In addition, as described in part VII.D.4 of this Summary of Comments and Explanation of Revisions section, an unrelated manufacturer (such as an original equipment manufacturer) that uses intangible property that consists of a manufacturing method or process, as provided in § 1.250(b)–4(d)(2)(ii)(C), is treated as the end user if the finished good has purchased (or licensed) the manufacturing method or process intangible property from an unrelated party.

B. Foreign Person

The proposed regulations provided that a recipient is treated as a foreign person only if the seller obtains documentation of the recipient’s foreign status and does not know or have reason to know that the recipient is not a foreign person. See proposed § 1.250(b)–4(c)(1). The proposed regulations
provided several types of permissible documentation for this purpose, such as a written statement by the recipient indicating that the recipient is a foreign person. See proposed § 1.250(b)–4(c)(2)(i).

As explained in part II of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations remove the specific documentation requirements with respect to certain requirements, including the foreign person requirement, and further identify the substantive standards by which taxpayers must meet the requirements of the FDI regime. To address situations in which taxpayers may not be able to determine whether the recipient is a foreign person within the meaning of section 7701(a)(1), the final regulations provide that the sale of property is presumed made to a recipient that is a foreign person if the sale is as described in one of four categories: (1) Foreign retail sales; (2) sales of general property that are delivered to an address outside the United States; (3) in the case of general property that is not sold in a foreign retail sale or delivered overseas, the billing address of the recipient is outside the United States; or (4) in the case of sales of intangible property, the billing address of the recipient is outside the United States. See § 1.250(b)–4(c)(2)(i) through (iv). The presumption does not apply if the seller knows or has reason to know that the sale is to a recipient other than a foreign person. See § 1.250(b)–4(c)(1). The final regulations also specify that in the case of manufacture, assembly, or other processing outside the United States, the seller must generally obtain certain documentation for this purpose, such as proof of shipment of the property to a foreign person that is related to the U.S. intermediary, the comment suggested that unrelated counterparties could demand compensation for any restructuring. The comment also noted that the title to section 250(b)(5)(B) references rules for “[p]roperty or services provided to domestic intermediaries.” suggesting that Congress contemplated situations where sales to a U.S. intermediary could be treated as a sale to a non-U.S. person, although the rule itself does not reference domestic intermediaries.

As explained in the preamble to the proposed regulations, section 250(b)(4)(A)(i) requires that a sale of property (which includes licenses of intangible property) be made to a person who is not a United States person. This requirement ensures that only the domestic corporation that makes the final sale to a foreign person can claim a section 250 deduction for a FDI sale (rather than allowing the benefit to multiple unrelated domestic corporations that all participate in a sale). Furthermore, the Treasury Department and the IRS do not agree that the heading to section 250(b)(5)(B) implies an exception to the requirement in section 250(b)(4)(A)(i) that the sale be to a foreign person. The rule in section 250(b)(5)(B)(i) refers only to other “persons” and is not limited to domestic persons. In contrast, the Treasury Department and the IRS have determined that it is necessary and appropriate to provide a special rule for military sales in recognition that sales pursuant to the Arms Export Control Act are required to be made to the U.S. government, but are in effect sales to a foreign government. Therefore, the comment is not adopted.

C. Foreign Use of General Property

1. Determination of Foreign Use in General

The proposed regulations provided that the sale of general property is for a foreign use if either the property is not subject to domestic use within three years of delivery of the property or the property is subject to manufacture, assembly, or other processing outside the United States. See proposed § 1.250(b)–4(d)(1)(ii) and (iii). Consistent with the reasonable interpretation of the comments, the Treasury Department and the IRS have determined that a more flexible
definition of foreign use of general property that accounts for the possibility of some limited domestic use is more reasonable for taxpayers to apply and for the IRS to administer. Accordingly, the final regulations eliminate the requirement that the taxpayer have no “reason to know” of some domestic use for sales of general property. As described in part VII.C.2 through 8 of this Summary of Comments and Explanation of Revisions section, the final regulations generally provide that the sale of general property is for a foreign use if the seller determines that such sale is to an end user described in one of five categories. See § 1.250(b)–4(d)(1)(ii)(A)–(F).

2. Delivery of Property Outside the United States

The first category of sales that are for a foreign use is sales to a recipient that are delivered by a freight forwarder or carrier to an end user if the end user receives delivery of the general property outside the United States. See § 1.250(b)–4(d)(1)(ii)(A). The Treasury Department and the IRS have determined that, in general, if an end user receives delivery of general property outside the United States, the general property will be “for a foreign use” as contemplated by section 250(b)(4)(A)(ii) and additional detail regarding the actual use of the property is unnecessary. However, it would be inappropriate to treat these sales as FDDEI sales if the seller and buyer arrange for general property to be delivered to a location outside the United States only to be redelivered for use or consumption into the United States with a principal purpose of causing what would otherwise not be a FDDEI sale to be treated as a FDDEI sale. Therefore, § 1.250–4(b)(1)(ii)(A) provides an anti-abuse rule to address these concerns.

3. Location of Property Outside the United States

The second category of sales that are for a foreign use is sales of general property to an end user where the property is already located outside the United States, and includes foreign retail sales. See § 1.250(b)–4(d)(1)(ii)(B). In general, sales of general property from a foreign retail sale will be used outside the United States. While it may be possible that some end users will purchase property in a foreign retail store and use it solely within the United States, the Treasury Department and the IRS have determined that requiring a determination of the actual use of these sales would be unnecessarily burdensome.

4. Resale of Property Outside the United States

The third category of sales for a foreign use is sales to a recipient such as a distributor or retailer that will resell the general property, if the seller determines that the general property will ultimately be sold to end users outside the United States. See § 1.250(b)–4(d)(1)(ii)(C). This category is intended to apply to sales to distributors and retailers, but may also apply to other sales to foreign persons for resale. In addition, the final regulations provide that for purposes of this rule, the seller must substantiate the portion of sales to end users outside the United States under the rules described in parts II and VII.C.9 of this Summary of Comments and Explanation of Revisions section.

The proposed regulations contained alternative documentation requirements for a sale of multiple items of general property that because of their fungible nature are difficult to specifically trace to a location of use (fungible mass). See proposed § 1.250(b)–4(d)(3)(iii). Under the proposed regulations, a seller establishes foreign use of a fungible mass through market research, including statistical sampling, economic modeling and other similar methods. Id. The proposed regulations also provided that if a seller establishes that 90 percent or more of a fungible mass is for a foreign use, the entire fungible mass is treated as for a foreign use and if the seller cannot establish that 10 percent or more of the sale of a fungible mass is for a foreign use, then no part of the fungible mass is treated as for a foreign use. Id.

One comment stated that the fungible mass rules created overly stringent documentation requirements that were unnecessary, impractical, and unreliable because a U.S. seller would need to perform market research in order to meet the 90 percent threshold to qualify for foreign use. Conversely, the comment noted that a U.S. seller that could not meet the 10 percent threshold through market research could see their deduction eliminated in its entirety. The comment suggested instead a rebuttable presumption that fungible mass property sold outside the United States is for a foreign use unless a taxpayer knows or has reason to know that a material amount will be used within the United States.

In response to the comment, the final regulations eliminate the 10 percent and 90 percent thresholds and apply a proportionate rule. See § 1.250(b)–4(d)(1)(ii)(C). Under this rule, in the case of a sale of a fungible mass of general property, if a portion of the property sold is not for a foreign use, the seller may rely on the proportion of the recipient’s resales of fungible mass to end users outside the United States to determine its proportion of ultimate sales to end users outside the United States. Id. In addition, the Treasury Department and the IRS have determined that prescribing specific methods such as market research, statistical sampling, economic modeling, and other similar methods to determine foreign use from the sale of a fungible mass of general property (or a sale of any general property) is unnecessary given the more flexible approach to documentation. It should be noted that market research or information from public data, such as general internet searches of secondary sources, is generally not a source of reliable information. In contrast, statistical sampling, economic modeling, or market research based on the taxpayer’s own data will be more reliable.

5. Electronic Transfer of Digital Content Outside the United States

The fourth category of sales for a foreign use is for sales of digital content that are transferred electronically. Sales of digital content transferred in a physical medium are for a foreign use if described in one of the first three categories. The final regulations provide that digital content that is transferred electronically is for a foreign use if it is sold to a recipient that is an end user that downloads, installs, receives, or accesses the digital content on the end user’s device outside the United States. See § 1.250(b)–4(d)(1)(ii)(D). However, if this information is unavailable, such as where the device’s internet Protocol address (“IP address”) is not available or does not serve as a reliable proxy for the end user’s location (for example, using a business headquarters’ IP address when it has employees located both within and outside the United States who use the digital content), then the sale is for a foreign use if made to an end user with a foreign billing address, but only if the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than $50,000.

6. International Transportation Property

The fifth category of sales for a foreign use is sales of international transportation property. The proposed regulations provided a special rule for determining whether transportation property, like aircraft, vessels, motor vehicles or similar property that travels internationally is
sold for foreign use and therefore constitutes a FDDEI sale. See proposed § 1.250(b)–4(d)(2)(iv). Under this rule, such transportation property is sold for foreign use only if during the three-year period from the date of delivery of the property the property is located outside the United States more than 50 percent of the time and more than 50 percent of the miles traversed in the use of such property will be traversed outside the United States. The seller can establish that these criteria are satisfied by obtaining a written statement from the recipient that the property is anticipated to satisfy these tests over the requisite three-year period. See proposed § 1.250(b)–4(d)(3)(i)(A). With respect to air transportation, the proposed regulations provided that, for purposes of the above tests, international transportation property is deemed to be within the United States at all times during which it is engaged in transport between any two points within the United States, except where the transport constitutes uninterrupted international air transportation within the meaning of section 4262(c)(3) and the regulations under that section. See proposed § 1.250(b)–4(d)(2)(iv).

One comment suggested supplementing these tests with a rebuttable presumption that any foreign-registered aircraft sold to a foreign person is for foreign use. The comment observes that “cabotage rules” significantly restrict the use of foreign-registered aircraft within the United States such that a foreign-registered aircraft cannot travel between two points in the United States unless the route is part of a through trip on the way to, or coming from, a foreign destination. The comment further noted that the ability of foreign persons to register aircraft in the United States is restricted. Therefore, the comment proposed that a document evidencing foreign registration of an aircraft to a foreign person should suffice to establish foreign use.

Other comments suggested changes to thresholds in the foreign use tests in the proposed regulations. Several comments suggested reducing the thresholds from 50 percent to 20 percent and making these tests disjunctive. Another comment would retain the 50 percent threshold but eliminate the three-year period so that the foreign use test would only have to be satisfied as of the filing date of the FDII return, and that the taxpayer be permitted to elect annually to bifurcate income from foreign and domestic use based on the percentage of actual time spent or miles traversed outside and inside the United States. A different comment suggested reducing the three-year period to one year after the date of delivery.

The Treasury Department and the IRS generally agree with the comment that place of registration is appropriate as evidence of “use.” Therefore, the final regulations provide that international transportation property used for compensation or hire is considered for a foreign use if it is sold to an end user that registers the property with a foreign jurisdiction. See § 1.250(b)–4(d)(1)(ii)(E). The final regulations provide that other international transportation property is considered for a foreign use if sold to an end user that registers the property with a foreign jurisdiction and the property is hangered or primarily stored outside the United States. See § 1.250(b)–4(d)(1)(ii)(F).

This rule reflects the fact that many recipients of international transportation property will not be further using the property for the provision of international transportation services. As a result, the property will be primarily used in the place it is registered or otherwise hangered or stored. Even if such property enters the United States, because it originated in a different country, the use should not be considered domestic use because the international transportation property will generally be located outside the United States. As a result, the Treasury Department and the IRS have determined that there is no need to determine the amount of time or miles that such property is inside or outside the United States.

Finally, one comment suggested expanding the definition of transportation property to include parts of transportation property like engines, tires, electronic equipment and spare parts, even if such parts would not otherwise satisfy the foreign use tests for general property. The comment expressed concern that the sale of parts that were included within international transportation property could fail the foreign use test for general property because the parts may enter the United States as part of the transportation property. At the same time, such parts would be ineligible for the special rules for international transportation property. The comment suggested expanding the definition of transportation property to include additional parts, even if such parts would not otherwise satisfy the foreign use tests for general property.

This comment is not adopted. Such a rule would be administratively burdensome and could lead to inconsistency through the application of two sets of rules to the same transaction and property. Furthermore, the Treasury Department and the IRS have determined that the concerns that were the basis for the comment are generally addressed through the adoption of the new general rules with respect to general property and international transportation property. In particular, parts that are used outside the United States by an end user, including when incorporated into transportation property through manufacturing, assembly or other processing, would generally be considered for a foreign use under the general test for general property. As described in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, this is the case even if there is the possibility of some domestic use of the property.

7. Manufacturing, Assembly, or Other Processing Outside the United States

As described in part VII.C.1 of this Summary of Comments and Explanation of Revisions section, the proposed regulations provided that the sale of general property is for a foreign use if either the property is not subject to domestic use within three years of delivery of the property or the property is subject to manufacturing, assembly, or other processing outside the United States before any domestic use of the property. See proposed § 1.250(b)–4(d)(2)(i). Under the proposed regulations, general property is subject to manufacturing, assembly, or other processing only if it meets either of the following two tests: (1) There is a physical and material change to the property, or (2) the property is incorporated as a component into a second product. See proposed § 1.250(b)–4(d)(2)(iii)(A).

The proposed regulations clarified that a physical and material change does not include “minor assembly, packaging, or labeling.” See proposed § 1.250(b)–4(d)(2)(iii)(B). Whether property has undergone a physical and material change (as opposed to minor assembly, packaging, or labeling) is determined based on all the relevant facts and circumstances. The proposed regulations provided that general property is incorporated as a component into a second product only if the fair market value of the property when it is delivered to the recipient constitutes no more than 20 percent of the fair market value of the second product, determined when the second product is completed. See proposed § 1.250(b)–4(d)(2)(iii)(C). For purposes of this rule, the proposed regulations included an aggregation rule providing that if the seller sells multiple products that are incorporated into the second product, all of the property sold by the seller is
incorporated into the second product is treated as a single item of property.

Several comments recommended that the final regulations provide more flexibility in satisfying the manufacturing, assembly, or other processing rule, especially in the context of sales to foreign unrelated parties where information to establish the two distinct tests may not be readily available. Several comments suggested that the “physical and material change” test should be satisfied where general property is subject to processing or manufacturing activities that are substantial in nature and that are generally considered to constitute manufacturing or production of a substantially different product. Other comments suggested that the final regulations could provide for such a “substantial in nature” rule as a third test in addition to the “physical and material change” and component tests. Comments also recommended a rebuttable presumption where a taxpayer could show that the physical and material change test had been met through reasonable documentation created in the ordinary course of its business. In addition, these comments suggested that general property sold to an unrelated party can be presumed to be sold for use, consumption, or disposition in the country of destination of the property sold, unless the taxpayer knows, or has reason to know otherwise.

With respect to the component test, comments suggested the 20 percent threshold should function as a safe harbor similar to the safe harbor under the subpart F components manufacturing rule in §1.954–3(a)(4)(iii). Another comment suggested the addition of a facts and circumstances test. Citing concerns with lack of readily available information, comments further suggested allowing taxpayers to satisfy the 20 percent threshold through market research or other methods similar to the fungible mass rule. Another comment suggested the 20 percent threshold was too low and should be increased to 50 percent. In the case of sales of multiple components by the same seller, comments suggested that the sales should not be integrated unless actual knowledge exists as to where the products will be incorporated (such as knowledge that the product will be included in the same second product or the nature of the component compels inclusion into the second product).

Comments also noted similarities and differences with the manufacturing, assembly, or other processing requirement under FDII and the manufacturing rules under subpart F. In particular, comments pointed out that in the subpart F context, the rules address parties under common control where information is more readily available, while in the FDII context, information may not be available. A CFC’s foreign base company sales income does not include income of a CFC derived in connection with the sale of personal property manufactured, produced, or constructed by such corporation. Notably, Treasury regulations provide two special manufacturing rules, often referred to as, the “substantial transformation” test and the “component parts” test. See §1.954–3(a)(4)(ii) and (iii). Under the first test, if property is “substantially transformed” by the CFC before sale, the property sold is considered manufactured, produced, or constructed by the selling corporation. Under the second test, a sale of property is treated as the sale of a manufactured product, rather than the sale of component parts, if the assembly or conversion of the component parts into the final product by the selling corporation involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property. A CFC is deemed to have manufactured the product if its conversion costs represent 20 percent or more of the total cost of goods sold.

In response to comments, the final regulations make several changes to the rule for manufacturing, assembly, and other processing. The final regulations clarify that general property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state. See §1.250(b)–4(d)(1)(v)(B)(1) (Example 1). The final regulations also modify the aggregation rule so that it applies only if the seller sells the property to the buyer and knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). The final regulations specify that a seller has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process contains information that indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product. See §1.250(b)–4(d)(1)(iii)(C).

8. Manufacturing, Assembly, or Other Processing in the United States

Section 250(b)(5)(B)(i) provides that if a seller sells property to another person (other than a related party) for further manufacture or other modification within the United States, the property is not treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use. Section 250(b)(5)(B)(i) could apply in the case of a sale directly to a person that is a foreign person if the property is subject to further manufacture or other modification in the United States after the sale but before the property is delivered to the end user.

As described in the preamble to the proposed regulations, the proposed regulations did not contain specific rules corresponding to section 250(b)(5)(B)(i) because that rule is encompassed within the general rules relating to FDDEI sales in the proposed regulations. The final regulations generally provided that general property is not for a foreign use if the property
is subject to a domestic use, which includes manufacture, assembly, or other processing within the United States. See proposed § 1.250(b)–4(d)(2)(i) and (ii)(B).

Because the final regulations no longer define “foreign use” by reference to whether the property is subject to a domestic use, the rule in section 250(b)(5)(B)(i) is no longer encompassed within the general rules in the regulations relating to FDDEI sales. Accordingly, the final regulations include a rule that provides that if the seller sells general property to a recipient (other than a related party, for which separate rules apply) for manufacturing, assembly, or other processing within the United States, such property is not sold for a foreign use even if the requirements for foreign use are subsequently satisfied. See § 1.250(b)–4(d)(1)(iv). For consistency, the final regulations cross reference the rules described in part VII.C.7 of this Summary of Comments and Explanation of Revisions section for the meaning of “manufacturing, assembly, or other processing.”

9. Specific Substantiation for Foreign Use of General Property

The final regulations specifically require a taxpayer to substantiate foreign use for general property for sales of general property to resellers and manufacturers. See § 1.250(b)–4(d)(3)(ii) and (iii). In the case of sales to resellers, a taxpayer must maintain and provide credible evidence upon request that the general property will ultimately be sold to end users located outside the United States. See part VII.C.4 of this Summary of Comments and Explanation of Revisions section. This requirement is satisfied if the taxpayer maintains evidence of foreign use such as the following: a binding contract that limits sales to outside of the United States, proof that the general property is sold only for a foreign market, or proof that the shipping costs would be prohibitive.®

Accordingly, the final regulations provide more detailed guidance on determining where sales for a foreign use generally be necessary to determine the location of end users. Another comment suggested the substantiation requirements for foreign use will be continued on the following page.

The proposed regulations provided that a sale of intangible property (which includes a license or any transfer of such property in which gain or income is recognized under section 367) is for a foreign use to the extent revenue is earned from exploiting the intangible property outside the United States. See proposed § 1.250(b)–4(e)(1). Where the revenue is considered earned is generally determined based on the location of the end user. See proposed § 1.250(b)–4(e)(2). The seller of the intangible property must satisfy certain documentation requirements showing foreign use and have no knowledge, or reason to know, that the portion of the sale of the intangible property for which the seller establishes foreign use is not for foreign use. The proposed regulations also provided rules to determine foreign use for the sale of intangible property to foreign persons in exchange for periodic payments or a lump sum payment. See proposed § 1.250(b)–4(e)(2).

2. Substantiating Foreign Use of Intangible Property

Several comments recommended changes to the documentation rules. In response to those comments, and as explained in part II of this Summary of Comments and Explanation of Revisions section, the final regulations adopt a more flexible approach to documentation, but require a taxpayer to specifically substantiate foreign use for sales of intangible property. See § 1.250(b)–4(d)(3)(iv). A taxpayer must maintain and provide credible evidence upon request that a sale of intangible property will be used to earn revenue from end users located outside the United States. A taxpayer may satisfy the substantiation requirement by maintaining certain items as specified in the final regulations. See § 1.250(b)–4(d)(3)(iv)(A). For example, a binding contract providing that the intangible property can be exploited solely outside the United States will generally satisfy the substantiation requirements demonstrating foreign use of the intangible property. See § 1.250(b)–4(d)(3)(iv)(A). Certain information from the recipient obtained or created in the ordinary course of business or corroborating evidence maintained by the taxpayer that credibly supports the information may also suffice. See § 1.250(b)–4(d)(3)(iv)(B)–(C).

3. Determining Foreign Use of Intangible Property

Comments suggested that sales with respect to intangible property be divided into several subcategories. One comment suggested dividing intangibles into production and marketing categories, with income from sales of production intangibles used in the development or manufacture of products outside the United States being FDDEI sales regardless of the location of the end user, and income from sales of marketing intangibles analyzed based on the location of the end user. Another comment suggested three subcategories of intangible sales: (i) Sales of manufacturing intangibles to foreign unrelated parties, which would be considered for a foreign use if manufacturing occurs outside the United States; (ii) sales of manufacturing intangibles to related parties, which would be considered for a foreign use if the product is sold to a foreign person for foreign use; and (iii) sales of marketing intangibles, which would be considered for a foreign use if the end user purchases the resulting product outside the United States.

Consistent with the proposed regulations, the final regulations provide that foreign use of intangible property is determined based on revenue earned from end users located within versus outside the United States. See § 1.250(b)–4(d)(2)(i). The focus on the location of end users is derived from the requirement in section 250(b)(5)(A) that sales for a foreign use require “use” or “consumption” outside the United States and the end user is the person that ultimately consumes or uses the intangible property. In the case of legally protected intangible property (such as patents or trademarks), the location in which legal rights to the intangible property are granted and exploited generally determines the location of the end users. Therefore, for example, in the case of intangible property such as patents that provide rights only for markets outside the United States, the end users will generally be located solely outside the United States. In the case of intangible property that allows for worldwide exploitation (or intangible property that is not legally protected), a more specific determination of end users will generally be necessary to determine the portion of intangible property income that is for a foreign use versus not for a foreign use.
revenue is earned from end users of the intangible property, including rules for intangible property embedded in general property or used in connection with the sale of general property, intangible property used to provide services, and intangible property used in research and development. See § 1.250(b)–4(d)(2)(ii). The final regulations also include rules for determining revenue earned from sales of a manufacturing method or process, which is similar to the separate rule for “production intangibles” or “manufacturing intangibles” that was suggested by comments.

Revenue is generally earned from intangible property used to manufacture products or provide services through sales of such products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sublicensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.”

Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which is generally the person who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the service recipient. See § 1.250(b)–4(d)(2)(ii)(D). These rules provide the same determination of location of end user for sales or licenses of intangible property used in research and development. See § 1.250(b)–4(d)(2)(ii)(D).

4. Intangible Property Used in Manufacturing

The preamble to the proposed regulations requested comments regarding whether to adopt a rule for intangible property similar to proposed § 1.250(b)–4(d)(2)(ii)(B) (treating a sale of general property as for a foreign use if the property is subject to manufacturing, assembly, or other processing outside the United States). Several comments supported a rule that treats the sale of intangible property as for a foreign use where intangibles are used in manufacturing that takes place outside the United States. Some of the comments also suggested that footnote 1522 of the Conference Report to the Act supported this position because that footnote stated that the application is limited to only tangible property that is subject to manufacturing, assembling, or other processing outside the United States.6

Based on comments received, the final regulations provide a special rule for sales to a foreign unrelated party of a manufacturing method or process or for know-how used to put the manufacturing method or process to use in manufacturing (the “manufacturing method or process rule”). See § 1.250(b)–4(d)(2)(ii)(C). The final regulations provide that when this rule applies, then the foreign unrelated party is treated as an end user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end user located within the United States.

For purposes of this rule, reason to know is determined based on the information received from the recipient during the sales process. See § 1.250(b)–4(d)(2)(ii)(C)(1).

The manufacturing method or process rule does not apply to sales or licenses of a manufacturing method or process to an unrelated foreign party for purposes of manufacturing products for or on behalf of the seller of the manufacturing method or process or any of the seller’s affiliates. See § 1.250(b)–4(d)(2)(ii)(C)(2).

Applying the manufacturing method or process rule to determine the end user with respect to such an arrangement, such as a contract or toll manufacturing arrangement, is not appropriate because the seller or related party to the seller is using the manufacturing method or process for itself. Such use by the seller is effectively a circular transfer of the intangible property back to the seller. However, the sale of the manufactured products by the seller of the manufacturing method or process or the seller’s affiliates can still qualify as a FDDEI sale under other provisions such as § 1.250(b)–4(d)(1)(i).

The manufacturing method or process rule applies only to certain types of intangibles that are used in the manufacturing process. The distinction between the types of intangibles that qualify for this rule and other types of intangibles that may be used by manufacturers is based on a distinction between use of a patented method or process and use of other types of patented items. In all other cases, the foreign use of intangible property is determined based on revenue earned from end users located within versus outside the United States.

The manufacturing method or process rule applies only to sales to unrelated parties (including sales made through related parties that ultimately result in a sale of the manufacturing method or process to an unrelated party). Section 250(b)(5)(C) provides that sales to related parties are treated as for a foreign use only if the property is ultimately sold or used in connection with property that is sold to an unrelated party who is not a United States person. While § 1.250(b)–6(c) gives effect to this rule by providing special rules for sales of general property to related parties (which apply in the case of sales of property to related parties for further manufacturing), those rules do not apply to sales of intangible property. Under the proposed regulations, a related party rule was not needed for sales of intangible property, including property consisting of a manufacturing method or process, because the proposed regulations generally provided that intangible property used in the manufacture of a product is treated as exploited at the location of the end user when the product is sold to the end user.

Proposed § 1.250(b)–4(e)(2)(ii). Under the final regulations, limiting the manufacturing method or process rule to unrelated party sales serves the purpose of ensuring that such sales are FDDEI sales only to the extent contemplated by section 250(b)(5)(C).

For example, if the taxpayer sells to a foreign related party a manufacturing method used to produce general property, then the sale of the manufacturing method is for a foreign use to the extent that the foreign related party’s sales of the general property are for a foreign use under the rules applicable to sales of general property. See § 1.250(b)–4(d)(2)(ii)(A). This result is generally consistent with the result if the related party sale had instead been of general property that was used in manufacturing.

5. Bundled Intangible Property

One comment requested that where a taxpayer licenses a bundle of intangibles, it should be allowed to elect the application of the potentially applicable rules based either on the predominant feature of the bundle or using any reasonable method. The Treasury Department and the IRS recognize that intangible property is sometimes sold or licensed as a bundle, such as the license of patents, copyrights, trademarks, tradenames, and
know-how in a single transaction, without specifying the amount of payment required for each item of intangible property. The final regulations provide for a predominant character determination when a transaction has multiple elements, such as a service and sale or a sale of general property and intangible property, to determine whether to apply the provisions for sales of general property, sales of intangible property, or the provision of services. See §1.250(b)-3(d).

In the case of a sale of license of bundled intangible property, the final regulations will generally base the location of exploitation on the location of the end user who ultimately uses the general property in which the intangible property is embedded or associated with, or, if the intangible property is used to provide a service, the location of the service recipient. See §1.250(b)-4(d)(2)(ii)(A)-(B), (D). Only in an unrelated party transaction involving the manufacturing method or process rule will the end user location be determined differently than a transaction involving intangible property used with general property, services, or research and development. However, the manufacturing method or process rule does not determine the location of the end user of other intangible property bundled with the manufacturing method or process. As a result, the final regulations do not provide for an election to treat or characterize the sale or license of bundled intangible property that includes manufacturing method or process intangibles as well as other intangible property as falling entirely within one of the categories of intangible property specified in §1.250(b)-4(d)(2).

6. Treatment of Product Intangibles as Components

One comment suggested that the final regulations include a rule that would treat certain “product intangibles” as a component of the finished product and provide a rule that is analogous to the rule for sales of general property that is incorporated as a component of another product outside the United States. See §1.250(b)-4(d)(1)(iii)(A) and (C). The final regulations do not adopt this comment. Intangible property has no physical properties, and therefore cannot be incorporated into a finished good or otherwise be a “component” of the finished good in the same way as items of general property that are considered to be components. See section 367(d)(4) (defining intangible property). For example, a patent on an article of manufacture is not a component of the finished product protected by the patent. Similarly, while a trademark design may be placed on a component of a finished product, the trademark itself is not a component of the finished product. Therefore, the final regulations do not provide a component rule for the sale or license of intangible property. Instead, the general rule that use is determined based on where the intangible property is exploited applies to these types of sales.

7. Intangible Property Used To Enhance Other Intangible Property

One comment discussed intangibles that are sold to an unrelated foreign person who enhances the intangible (for example, by adapting it to local markets) or uses the intangible property to develop other intangible property and subsequently sells such enhanced or newly created intangible property outside the United States. In these situations, the comment recommended that the sale of the original intangible property should be presumed to be for foreign use if the location of the research and development is outside the United States and the recipient is unrelated to the original seller, and suggested that footnote 1522 of the Conference Report supports such a rule. The final regulations do not adopt the comment. As discussed in part VII.D.3 of this Summary of Comments and Explanation of Revisions section, revenue is generally earned from intangible property used to manufacture products or provide services through sales of such products or services, or from limited use licenses of the intangible property, whether those sales, services, or limited use licenses are executed by an owner, licensee, or sublicensee of the intangible property. Until revenue is earned from sales, services, or limited-use licenses to the end user that ultimately consumes the property or receives the service, the intangible property is generally not “exploited.” Although the final regulations provide a limited exception from this end user requirement for intangible property that consists of a manufacturing method or process (see part VII.D.4 of this Summary of Comments and Explanation of Revisions section), no exception is included for intangible property used to enhance or create other intangible property. The Treasury Department and the IRS have determined that the activities described in the comment do not constitute “use” by end users but rather are intermediate steps in the development of intangible property before being exploited and used. In addition, nothing in the text of section 250 or footnote 1522 of the Conference Report suggests that a different definition of foreign use should apply in the case of research and development.

However, in response to comments, the final regulations clarify the rule for sales of intangible property used to develop other intangible property or to modify existing intangible property. See §1.250(b)-4(d)(2)(ii)(D). In such a case, the end user of the intangible property (primary IP) used to develop other intangible property or to modify existing intangible property (secondary IP) is the end user of the property in which the secondary IP is embedded. If the secondary IP is used to provide a service, the end user is the unrelated party recipient. If the secondary IP qualifies as a manufacturing method or process (as described in part VII.D.4 of this Summary of Comments and Explanation of Revisions section), then the rules applicable to sales of a manufacturing method or process apply to determine if the sale of the secondary IP is for a foreign use. See §1.250(b)-4(d)(2)(ii)(C).

8. Intangible Property Used To Provide Services

One comment noted that intangible property may be sold to recipients that provide services, rather than solely to recipients that manufacture and sell goods, and that the proposed regulations did not specifically address the sale of intangible property used to provide services. For such sales, the comment recommended that the intangible property be treated as exploited in the locations in which the recipient receives legal rights to the intangible property under the terms of the contract or other applicable law. Another comment recommended that for sales of intangible property to unrelated persons for use in the provision of services, the sales should be presumed to be for foreign use if the services will be performed outside the United States without regard to the location of the person or persons receiving such services.

Revenue may be earned from intangible property through the provision of services, but until that revenue is earned, the intangible property is generally not used or “exploited.” Consistent with this view, the final regulations generally place the location of use of the intangible property with the location of the end user, which in the case of intangible property used to provide a service, is the service recipient. See §1.250(b)-4(d). These rules are generally consistent with the location in which legal rights to the intangible property...
are granted and exploited, with exploitation generally being located where the end user ultimately consumes the property or the services the intangible property is used to provide. See § 1.250(b)–4(d)(2)(i). The rules in § 1.250(b)–5 for FDDEI services generally apply for purposes of determining the location of the end user. Therefore, for example, the location of the end user of intangible property that is used to provide advertising services is determined based on the location of the individuals viewing the advertisements. See § 1.250(b)–5(e)(2)(ii).

However, the regulations do not provide a presumption that a sale to a foreign unrelated party that uses the intangible property to provide services outside the United States is presumed to be for foreign use. Such a presumption could produce results that would be inconsistent with the general approach for determining the location of use of intangible property by reference to the location of exploitation (which, in the case of intangible property used to provide services, is generally the location of the person or persons receiving such services), and the Treasury Department and the IRS have determined that a departure is not warranted in this case.

9. Determination of Revenue

The proposed regulations provided that when intangible property is sold in exchange for periodic payments, the extent to which the sale qualifies for a foreign use is made annually based on actual revenue earned by the recipient. Proposed § 1.250(b)–4(e)(2)(ii). In the case of a sale of intangible property in exchange for a lump sum payment, the extent to which the sale qualifies for foreign use is determined based on the ratio of total net present value the seller would have reasonably expected to earn from exploiting the intangible property outside the United States to total net present value the seller reasonably expected to earn from exploiting the intangible property worldwide. Proposed § 1.250(b)–4(e)(2)(iii). However, for purposes of satisfying the documentation requirements, the proposed regulations provided that in the case of sales in exchange for periodic payments that are not contingent on the revenue or profit of a foreign unrelated party, a taxpayer may establish the extent to which a sale of intangible property is for a foreign use using the principles applicable to sales in exchange for a lump sum payment, except that the taxpayer must make projections on an annual basis. See proposed § 1.250(b)–4(d)(3)(ii). This rule recognized that if the recipient of the intangible property makes periodic payments that are not contingent on the recipient’s sales or revenue, the recipient may not be willing to provide information about the end users of the intangible property.

a. Periodic Payments

Like the proposed regulations, the final regulations provide that for periodic payments (such as annual royalty payments or fixed installment payments) in exchange for rights to intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, taxpayers may estimate revenue earned by unrelated party recipients from any use of the intangible property based on the principles for determining revenue from lump sum sales, if actual revenue earned by the foreign party cannot be obtained after reasonable efforts. See § 1.250(b)–4(d)(2)(iii)(A). While the proposed regulations required estimated revenue to be determined on an annual basis when a taxpayer relies on this rule, the final regulations eliminate this requirement. The Treasury Department and the IRS have determined that when estimated revenue earned by unrelated party recipients must be used, information available at the time of the sale will be more reliable than information available subsequently. In addition, eliminating the requirement to determine estimated revenue annually reduces the administrative burden on the taxpayer. See § 1.250(b)–4(d)(2)(iii)(A).

b. Lump Sum Payments

One comment recommended that the seller be allowed to use revenue the recipient (rather than the seller) earns or expects to earn from use of the intangible property to determine the extent to which a sale of intangible property in exchange for a lump sum payment qualifies for foreign use because using the recipient’s expected or actual revenue is more accurate for determining foreign use. The comment acknowledges the administrative difficulty inherent in determining foreign use in the case of sales of intangible property for a lump sum payment and in obtaining actual or expected revenue data from the recipient.

In response to the comment, the final regulations allow taxpayers to use net present values using reliable inputs, which may include net present values of revenue the recipient expects to earn from the exploitation of the intangible property within and outside the United States if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. See § 1.250(b)–4(d)(2)(iii)(B). In determining whether such inputs are reliable, the extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor. The final regulations do not allow for use of actual revenue earned by the recipient from the use of the intangible property in a lump sum sale because actual revenue earned by the recipient for all the years the recipient uses the intangible property will not be known when the seller files its tax return for the tax year in which the sale of the intangible property occurred.

c. Payments for Manufacturing Method or Process

With respect to sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process, the final regulations provide that the revenue earned from the end user is equal to the amount received from the recipient in exchange for the manufacturing method or process. See § 1.250(b)–4(d)(2)(iii)(C). In the case of a bundled sale of intangible property consisting of a manufacturing method or process and other intangible property, the value of the manufacturing method or process relative to the total value of the intangible property must be determined using the principles of section 482.

E. Treatment of Certain Hedging Transactions

Several comments recommended that gain or loss from certain hedging transactions with respect to commodities be considered gain or loss from sales of general property. In support, the comments noted that the Federal income tax treatment of certain hedging transactions (for example, character and timing) corresponds to the treatment of the underlying physical transaction. Comments noted that these rules exist, in part, because the combined value of the hedging transaction and the underlying physical transaction generally reflects a taxpayer’s true economic exposure to the underlying physical commodity. Consistent with that approach and rationale, these comments recommended a similar approach for purposes of determining FDDEI sales income. The Treasury Department and the IRS agree that certain hedging transactions
should be treated in a manner that is similar to the treatment of the commodities hedged by those transactions. Furthermore, the Treasury Department and the IRS have determined that the adjustment for qualified hedging transactions should apply to all general property, rather than only commodities. Hedges of property other than commodities have the same economic effect as hedges of commodities, such that the rationale for determining FDDEI sales income from hedges by reference to hedges of commodities applies equally to other types of property. Accordingly, the final regulations generally provide that a corporation’s or partnership’s gross income resulting from FDDEI sales of general property is adjusted by reference to certain hedging transactions. See § 1.250(b)–4(f). The hedging transaction must meet the requirements of § 1.1221–2, including the identification requirement under § 1.1221–2(f), the transaction must hedge price risk or currency fluctuation with respect to ordinary property, and the property being hedged must be general property that is sold in a FDDEI sale. The Treasury Department and the IRS are considering issuing more detailed guidance on hedging transactions in the form of future proposed regulations. Comments are requested on this topic.

VIII. Comments on and Revisions to Proposed § 1.250(b)–5—FDDEI Services

Section 250(b)(4)(B) provides that FDDEI includes income from services provided by a domestic corporation to any person, or with respect to property, not located within the United States. Section 250 does not prescribe rules for determining whether a person or property is “not located within the United States.” Accordingly, proposed § 1.250(b)–5 provided rules for determining whether a service is provided to a person, or with respect to property, located outside the United States.

A. Categories of Services

The proposed regulations separated all services into five mutually exclusive and comprehensive categories: general services provided to consumers, general services provided to business recipients, proximate services, property services, and transportation services. See proposed § 1.250(b)–5(b). Whether a service is a FDDEI service is determined under the rules relevant to the applicable category.

One comment requested that the final regulations address how “digital services” are treated and classified under the FDDEI services regulations, although no recommendation was provided. Another comment requested more guidance on the application of the rules for general services to business recipients in the software-as-a-service context.

In response to these comments, the final regulations provide additional guidance, as described in parts VIII.B.1 and VIII.B.2.c of this Summary of Comments and Explanation of Revisions section, with respect to services that are “electronically supplied.” Services that are provided electronically typically will be categorized as general services because they will not meet the definitions of proximate services, property services, or transportation services. To provide additional guidance for determining the location of the recipients of services that are electronically supplied, the final regulations create a new category of general services defined as “electronically supplied services,” which includes general services (other than advertising services, described in the following sentence) that are delivered over the internet or an electronic network. See § 1.250(b)–5(c)(5). In addition, the final regulations create a new subcategory of general services for advertising services, including advertising services to display content via the internet, and provide additional guidance with respect to these services as described in part VIII.B.2.c of this Summary of Comments and Explanation of Revisions section. See § 1.250(b)–5(c)(1).

B. General Services

1. General Services Provided to Consumers

The proposed regulations provided that a consumer is located where the person resides when the service is provided and required documentation to establish the place of residence. See proposed § 1.250(b)–5(d)(2) and (3). Special rules for small transactions or small taxpayers allowed the taxpayer to establish the consumer’s location using the taxpayer’s billing address for the consumer. See proposed § 1.250(b)–5(d)(3)(ii).

Comments suggested that rather than limiting taxpayers to a finite list of documentation, the rules should allow taxpayers to support the status of the consumer as a person located outside the United States using documentation that is collected in the ordinary course of the taxpayer’s trade or business. As discussed in part II of this Summary of Comments and Explanation of Revisions section, the final regulations adopt a more flexible approach to documentation requirements compared to the proposed regulations. While the final regulations include specific substantiation requirements for certain elements of the regulations, no such rules are provided for general services to consumers. Furthermore, to minimize the burden associated with determining the residence of consumers, the final regulations provide that if the renderer does not have (or cannot after reasonable efforts obtain) the consumer’s location of residence when the service is provided, the consumer of a general service is treated as residing outside the United States if the consumer’s billing address is outside of the United States. See § 1.250(b)–5(d)(1). However, this rule does not apply if the renderer knows or has reason to know that the consumer does not reside outside the United States. The final regulations clarify that “reason to know” is determined based only on whether the information received as part of the provision of the service contains information that indicates that the consumer resides in the United States. Because this rule applies to all services provided to consumers (with the modification for electronically supplied services described in the next paragraph), the final regulations do not provide a special rule for small transactions or small taxpayers.

With respect to electronically supplied services that are provided to consumers, the final regulations provide that the consumer is deemed to reside at the location of the device used to receive the service, which may be an IP address, if available. However, if the renderer cannot determine the location of that device after reasonable efforts, the general rule based on billing address applies, subject to the renderer not knowing or having reason to know that the consumer does not reside outside the United States.

2. General Services Provided to Business Recipients

The proposed regulations determined the location of a business recipient based on the location of its operations, and the operations of any related party of the recipient, that receive a benefit (as defined in § 1.482–9(l)(3)) from such service. See proposed § 1.250(b)–5(e)(2) and (4). The proposed regulations provided that a service is generally provided to a business recipient located outside the United States to the extent that the renderer’s gross income from providing the service is allocated to the business recipient’s operations outside the United States. See proposed § 1.250(b)–5(e)(2)(i). Where the service
confers a benefit on the operations of the business recipient in specific locations, the proposed regulations provided that gross income of the renderer is allocated based on the location of the operations in specific locations that receive the benefit. See proposed § 1.250(b)–5(e)(2)(ii)(A). Where a service confers a benefit on the recipient’s business as a whole, or where reliable information about the particular portion of the operations that specifically receive a benefit from the service is unavailable, the proposed regulations provided that the service is deemed to confer a benefit on all of the business recipient’s operations. See proposed § 1.250(b)–5(e)(2)(ii)(A). For purposes of this rule, a business recipient is treated as having operations in any location where it maintains an office or other fixed place of business. See proposed § 1.250(b)–5(e)(2)(ii). The proposed regulations also required a taxpayer to obtain documentation sufficient to establish the location of a business recipient’s operations that benefit from the service. See proposed § 1.250(b)–5(e)(1) and (3). Under the proposed regulations, special rules for small transactions or small taxpayers allowed the taxpayer to establish the consumer's location using the taxpayer’s billing address for the consumer. See proposed § 1.250(b)–5(e)(3)(ii).

a. Operations of a Business Recipient of General Services

Several comments requested clarification regarding the definition of a business recipient’s operations. Some comments requested that the rule be expanded to include operations performed outside of the locations where the business recipient maintains an office or other fixed place of business. For example, where business recipients operate satellites or vessels, the comment suggested that business recipients should be treated as having operations at the location of the satellite or vessel.

The location of a business recipient’s operations that benefit from a general service is based on the geographical location where the business recipient’s activities are regular and continuous and is not based on the current location of mobile property such as satellites or vessels. Moreover, as noted in the next paragraph, the final regulations clarify that an office or other fixed place of business is a fixed facility through which the business recipient engages in a trade or business. See § 1.250(b)–5(e)(3)(i). In the case of services performed with respect to a satellite, the location of the business recipient that receives services with respect to the satellite is based on where the business recipient remotely performs activities with respect to the satellite (which could be within the United States or in a foreign country), rather than in space. In addition, services performed with respect to a vessel owned by a business recipient may qualify as proximate services or property services, depending on the nature of the services. Therefore, no further changes to the regulations are necessary to respond to the comment.

One comment requested further clarification of the term “fixed place of business,” such as whether it has the same meaning as it does for section 864(c) purposes. The comment did not specify whether using the meaning that the term has for section 864(c) purposes would be appropriate. However, the Treasury Department and the IRS have determined that it would not be appropriate to adopt the definition that applies for purposes of section 864(c). Because the final regulations define a business recipient as including all related parties of the recipient, whereas section 864(c) applies only to taxpayers by taxpayer basis, adopting the definition of an office or other fixed place of business that is in § 1.864–7 would cause confusion. However, the final regulations clarify that an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. See § 1.250(b)–5(e)(3)(i). In addition, the final regulations provide that for purposes of determining the location of the business recipient, the renderer may make reasonable assumptions based on the information available to it. The Treasury Department and the IRS recognize that taxpayers may not be able to obtain precise information about unrelated business recipients; therefore, the final regulations allow taxpayers to make reliable assumptions based on the information available to them. See id.

One comment requested guidance on how to determine the location of operations of a business recipient that does not have an office or fixed place of business. As an example, this could occur when the business recipient is a partnership that does not itself have any offices or employees but is managed by one or more of its partners. The comment suggested that in these circumstances, the final regulations presume that the business recipient has operations where it is formed or incorporated.

To address this comment, the final regulations provide that if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address. See § 1.250(b)–5(e)(3)(iii). The Treasury Department and the IRS considered using place of formation or place of incorporation, but determined that a business recipient’s billing address is generally available to the renderer and often bears a closer connection to the business recipient’s location of actual operations.

Finally, for the sake of concision, the final regulations expand the definition of a “business recipient” to include all related parties (as defined in § 1.250(b)–1(c)(19)) of the recipient. Compare § 1.250(b)–5(e)(3) with proposed § 1.250(b)–5(e)(4) (the latter providing, in a separate paragraph, that a reference to a business recipient includes a reference to any related party of the business recipient). However, to avoid circularity in circumstances where the business recipient is a related party of the taxpayer, in these circumstances, the term “business recipient” does not include the taxpayer. See § 1.250(b)–5(c)(3).

b. The Meaning of “Benefit”

One comment expressed concern that the proposed regulations’ reliance on the principles of § 1.482–9(i)(3), which explains when an activity is considered to provide a “benefit” to a recipient, would be difficult to apply outside the related party context because the renderer may not have the information necessary to perform a detailed analysis of the recipient’s operations. The comment suggests that transfer pricing standards should not be applied to evaluate transactions for purposes of section 250. The comment suggested that the term “benefit” should retain the reference to § 1.482–9(i)(3), but that the regulations should include a presumption that a general service provided to a foreign person benefits operations located outside the United States.

The Treasury Department and the IRS do not intend that the reference to § 1.482–9(i)(3) in the definition of “benefit” be interpreted as suggesting that taxpayers are required to perform a transfer pricing-like analysis of the recipient’s operations. Rather, the reference is intended to clarify, using a concept that is based on existing tax principles, that a service confers a benefit on operations of a recipient only if an uncontrolled party with similar operations would pay for the service under comparable circumstances. For example, if a service benefits particular operations of a business recipient so
indirectly or remotely that an unrelated party with similar operations would not pay for the service, the service does not confer a benefit on those operations. See § 1.482–9(l)(3)(ii). Accordingly, the final regulations retain the reference to § 1.482–9(l)(3) in defining “benefit.”

One comment also requested clarification regarding the types of benefits that must be considered in determining the location of the business recipient of a general service. The comment gives the example of a U.S. financial advisor providing advice to a foreign parent that is expected to increase the value of the foreign parent’s publicly traded stock, which would also benefit any U.S. subsidiaries by making their equity-based compensation more valuable. The implication of the comment is that it is unclear whether the U.S. subsidiaries receive a compensable benefit from the service provided because their employees are also shareholders of the foreign parent. As noted, the reference to § 1.482–9(l)(3) in the definition of “benefit” is intended to provide clarity on the meaning of “benefit” using a concept that is based on existing tax principles. As described in the previous paragraph, under § 1.482–9(l)(3)(ii), an activity is not considered to provide a “benefit” within the meaning of § 1.482–9(l)(3) if the benefit to the recipient is “so indirect or remote” that the recipient would not be willing to pay an unrelated party to perform a similar activity. Accordingly, in fact patterns such as the one described in the comment, where the service potentially confers a benefit on a related party of the recipient if the employees of the related party are also shareholders of the recipient, taxpayers must determine whether a related party with employees that are shareholders of a company would generally pay a financial advisor to provide advice to the company or whether the benefit to the related party is too indirect or remote. Section 1.482–9(l) provides comprehensive guidance, including twenty-one examples, to clarify the meaning of “benefit” using a concept that is based on existing tax principles.

Several comments addressed the proposed regulations’ rule for determining the location of the recipient of general services that benefits from the service. See proposed § 1.250(b)–5(e)(2). One comment suggested that the final regulations include language included in the preamble to the proposed regulations stating that for purposes of this rule, “the location of residence, incorporation, or formation of a business recipient is not relevant.” The final regulations adopt this comment. See § 1.250(b)–5(e)(1).

Several comments indicated that it would be difficult, if not impossible, for taxpayers to obtain information regarding which of a business recipient’s locations benefits from a service. While the proposed regulations allowed taxpayers in these circumstances to assume that the services will benefit all of the business recipient’s operations ratably, several comments suggested that this simplification was not sufficient. Several comments stated that these difficulties could be alleviated by making the transition rule in proposed § 1.250–1(b) permanent or by making the rules applicable to small businesses and small transactions available to all taxpayers. Several comments requested that the final regulations incorporate a presumption to simplify the rule, such as a presumption that any operations of the service recipient that are not known to be (or identifiable as) within the United States are presumed foreign or that services provided to a foreign person are presumed to benefit operations located outside the United States. The final regulations retain the same general approach as the proposed regulations for determining the location of the business recipient, with some revisions for concision, by providing that a service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on operations of the business recipient that are located outside the United States. See § 1.250(b)–5(e)(1). Like the proposed regulations, the final regulations provide that the determination of which operations of the business recipient benefit from a general service is made under the principles of § 1.482–9.

Further, the final regulations clarify that in applying these principles, (1) the service provided by the general service recipient’s operations within the United States (if any) that may benefit from the general service, and (3) the portions of the business recipient’s operations outside the United States that may benefit from the general service, are treated as if they are each one or more controlled taxpayers.

For purposes of applying the principles of § 1.482–9, the final regulations allow the IRS with flexibility to determine the extent to which a business recipient’s operations within or outside of the United States are treated as one or more separate controlled taxpayers, given that taxpayers generally will not have complete information regarding the operations of the business recipient. Any reasonable method can be used for determining the set and scope of business recipient operations that are treated as separate controlled taxpayers, for example, by segregating the operations on a per entity or per country basis, or by aggregating all of the business recipient’s operations outside the United States as one controlled taxpayer. For example, if a business recipient has operations in the United States, Country X, and Country Y, all of which may benefit from the taxpayer’s services, the business recipient’s operations in the United States, Country X, and Country Y could each be treated as separate controlled taxpayers. Alternatively, the business recipient’s operations in the United States, and the business recipient’s combined operations in Country X and Country Y, could be treated as two separate controlled taxpayers. The amount of the benefit conferred on each of the business recipient’s operations is determined under the principles of § 1.482–9(k).

To simplify the rule, the final regulations remove the provision stating that if a service benefits all of the business recipient’s operations, gross income of the renderer is allocated ratably to all of the business locations of the recipient, as that provision was redundant of the general rule. The final regulations also remove the provision that gross income of the renderer is allocated ratably to all of the business locations of the recipient if the renderer is unable to obtain reliable information regarding the specific locations of the operations of the business recipient to which a benefit is conferred. The Treasury Department and the IRS have determined that it would be inappropriate to allow a deduction that is not based on reliable information. Comments also suggested that the final regulations should define foreign operations by negation such that a service is considered provided to a business recipient outside the United States if that service is not provided to a business recipient inside the United States. These comments asserted that this would allow mobile activity performed in outer space, international airspace, or international water to qualify as FDDEI services. The Treasury Department and the IRS have determined that mobile services do not benefit a business recipient’s operations within the United States is

benefit from the general service, are treated as if they are each one or more controlled taxpayers.
The Treasury Department and the IRS have determined that the point of access serves as a reliable proxy for where the business recipient receives the benefit of the service. Therefore, the final regulations provide that with respect to electronically supplied services provided to a business recipient, the operations of the business recipient that benefit from the general service are deemed to be located where the general service is accessed. See § 1.250(b)–5(e)(2)(iii). The final regulations also provide that if the location where the business recipient accesses the electronically supplied service is unavailable (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services with respect to the business recipient (or any related party to the business recipient) are in the aggregate less than $50,000, the operations of the business recipient that benefit from the general service provided by the renderer are deemed to be located at the business recipient’s billing address. Id. The final regulations also include new examples for electronically supplied services. See § 1.250(b)–5(e)(5)(ii)(E) and (F) (Example 5 and 6).

d. Substantiating General Services Provided to Business Recipients

As discussed in part II of this Summary of Comments and Explanation of Revisions section, the final regulations replace the documentation requirements with new substantiation requirements for certain transactions, including general services provided to business recipients. The final regulations provide that a general service provided to a business recipient is a FDDEI service only if the taxpayer maintains sufficient substantiation to support its determination of the extent to which the service benefits a business recipient’s operations outside the United States. See § 1.250(b)–5(e)(4). A taxpayer satisfies this requirement by either obtaining corroboration evidence establishing the extent to which operations of the business recipient benefit from the service or preparing a statement that supports its determination with corroborating evidence. See § 1.250(b)–5(e)(4). The final regulations explain that the determination of the portion of the service that will benefit the business recipient’s operations located outside the United States may be based on evidence obtained from the business recipient or persons working for the recipient regarding the need for the service or data on the sales of the business recipient’s operations, or the taxpayer’s own records, such as time spent working with the business recipient’s different offices. See § 1.250(b)–5(e)(4)(ii).

As explained in part VII.C.4 of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS have determined that it is unnecessary to delineate which specific methods satisfy substantiation. If the taxpayer substantiates its determination with evidence provided by the business recipient, the final regulations do not specify what information must be included in the statement beyond requiring that it must establish the extent to which the service benefits operations located outside the United States. See § 1.250(b)–5(e)(4)(i). The Treasury Department and the IRS understand that service recipients may not be willing to provide information about their business to taxpayers. Accordingly, the final regulations do not require the evidence to specify which of the business recipient’s locations benefit from a service (for example, the business recipient’s European operations rather than its Asian operations), just the portion of the service that benefits operations outside the United States generally.

C. Proximate Services

The proposed regulations provided that the provision of a proximate service to a recipient located outside the United States is a FDDEI service. See proposed § 1.250(b)–5(f). The proposed regulations defined a proximate service as a service, other than a property service or transportation service, substantially all of which is performed in the physical presence of the recipient or, in the case of a business recipient, its employees. See proposed § 1.250(b)–5(c)(6).

Comments requested that the final regulations expand the definition of a proximate service by proposed § 1.250(b)–5(c)(6) to include services performed in the physical presence of additional persons working for a business recipient, including that business’s own employees, the employees of a related party of the recipient, or the recipient’s contract workers or agents. In response to these comments, the final regulations expand the definition of a proximate service to provide that it means a service, other than a property service or a transportation service, provided to a recipient, but only if substantially all of the service is performed in the physical presence of the recipient or persons working for the recipient such as...
employees, contractors, or agents. See § 1.250(b)–5(c)(8).

Comments also recommended that the final regulations provide that income received for the provision of proximate services, which must be performed outside the United States to qualify as a FDDEI service, is not treated as foreign branch income for purposes of section 250. The comments explained that taxpayers providing such services may potentially be deemed to operate a branch in the country in which the service occurs. The comments asserted that it is contrary to the purpose of section 250 for income from a FDDEI service (a proximate service provided outside the United States) to be excluded from FDDEI because the income is also foreign branch income. The comments made similar arguments with respect to property services, and one comment suggested that this concern applies to all services.

As explained in part IV.B of this Summary of Comments and Explanation of Revisions section, in response to comments, the final regulations confirm that there is one consistent definition of foreign branch income in both §§ 1.250(b)–1(c)(11) and 1.904–4(f)(2). The fact that the regulations under section 250 otherwise would treat certain income as eligible for FDII is irrelevant for purposes of determining whether the income is foreign branch income under section 904(d)(2)(J). Further, as acknowledged by the comments, providing a proximate service (or any other service) outside the United States does not necessarily create a foreign branch; therefore, not all income from proximate services performed outside the United States will be foreign branch income. Accordingly, the final regulations do not adopt these comments.

D. Property Services

The proposed regulations provided that a property service is a FDDEI service if it is provided with respect to tangible property located outside the United States, but only if the property is located outside the United States for the duration of the period the service is performed. See proposed § 1.250(b)–5(g).

1. Qualification of Property Services as FDDEI Services

Several comments recommended that the final regulations remove the mutually exclusive categories of services in proposed § 1.250(b)–5(b) because, according to the comments, they are inconsistent with section 250(b)(4)(B), which treats as FDDEI services those provided to any person, or with respect to property, not located within the United States. Comments asserted that the statute is disjunctive and requires that a service with respect to property gives rise to FDDEI if the service is provided to a person located outside the United States, regardless of the location of the serviced property.

The final regulations do not adopt these comments. Section 250(b)(4)(B) refers to persons and property disjointly, which indicates that Congress intended for there to be a category of services provided with respect to persons located outside the United States that would be FDDEI services and a separate category of services provided with respect to property located outside the United States that would be FDDEI services.

The proposed regulations gave effect to this intent. The statute and legislative history are ambiguous, however, as to whether Congress intended for all services provided with respect to persons located outside the United States and all services provided with respect to property located outside the United States to be included within the scope of the statute.

The Treasury Department and the IRS have determined that property services must be provided with respect to property located outside the United States in order to qualify as FDDEI services. The purpose of the section 250 deduction is to help neutralize the role that tax considerations play when a taxpayer chooses the location of intangible income attributable to foreign-market activity, that is, whether to earn such income through its U.S.-based operations or through its CFCs. See Senate Committee on the Budget, 115th Cong., “Reconciliation Recommendations Pursuant to H. Con. Res. 71,” at 375 (Comm. Print 2017).

Providing a FDII deduction for all property services performed in the United States with respect to property with owners located outside the United States, regardless of the property’s connection to foreign markets, would not further that purpose. Furthermore, even if the statute required that property services provided to any person located outside the United States could qualify as FDDEI services, the statute does not specify how to determine the location of such person. In the case of property services, the Treasury Department and the IRS have determined that basing the location of such person on the location of the property that the person owns is most consistent with the nature of a property service and the location of the benefit being provided. Therefore, even under the comments’ alternative reading of section 250(b)(4)(B), the Treasury Department and the IRS have determined that property services should be limited to those services provided to property located outside the United States.

However, in recognition of the fact that some property services performed within the United States may nonetheless be connected to foreign markets, as discussed in part VIII.D.2 of this Summary of Comments and Explanation of Revisions section, the final regulations expand the circumstances under which property services may qualify as FDDEI services notwithstanding the fact that the services are performed in the United States.

Several comments suggested that the final regulations clarify that the property services rules apply only to services that the taxpayer provides with respect to completed property that is in use by the property’s owner, and thus, that manufacturing-related services (such as toll manufacturing) are not property services, but rather general services. The comments suggested that if manufacturing services are treated as property services, manufacturing services performed in the United States will never give rise to FDDEI even if the sale of the same property to a foreign person for a foreign use would have been a FDDEI sale. In response to the comments, the final regulations specify that manufacturing services are property services but allow property services performed in the United States to qualify as FDDEI services under some circumstances. See § 1.250(b)–5(c)(7) and (g)(2). These changes are described in part VII.D.2 of this Summary of Comments and Explanation of Revisions section. Taken together, these changes allow manufacturing services performed in the United States to be FDDEI services in some circumstances.

In addition, one comment suggested that the definition of “property service” should be modified to remove the condition that only tangible property can be the subject of a property service. The comment states that services can be provided with respect to intangible property located outside the United States, and notes that the statute does not distinguish between services provided with respect to tangible and intangible property. The final regulations do not adopt this recommendation. Intangible property cannot be “located” outside the United States given that intangible property, by definition, does not have physical properties. Accordingly, the Treasury Department and the IRS determined that the general services rules, which look to the location of the recipient, are a more
appropriate framework for analyzing these types of services.

2. Services Provided With Respect to Property Temporarily Located in the United States

The proposed regulations provided that a property service is a FDDEI service only if the tangible property with respect to which the service is performed is located outside the United States for the duration of the period of performance, but requested comments regarding the treatment of property that is located in the United States only temporarily.

Comments requested that the final regulations provide that a property service is still a FDDEI service in part (or in full) if the property enters the United States temporarily while the services are performed, and included various recommendations for a safe harbor, including treating a property service as a FDDEI service if the property is present in the United States for a particular period while the property is out of commercial service. Some comments also requested that the types of property services that are FDDEI services should be expanded to include toll manufacturing arrangements for foreign persons. The comments pointed out that section 250(b)(4)(B) does not specify when property must be located outside the United States. The comments suggested that a special rule for property temporarily in the United States would be consistent with Congress’s objective in enacting section 250, which they assert was to incentivize taxpayers to serve the foreign market. In addition, one comment asserted that the proposed regulations penalize a seller for entering into a services arrangement (such as toll manufacturing) instead of a sales arrangement.

The final regulations generally adopt the comments. The Treasury Department and the IRS agree that in certain circumstances, treating property services as FDDEI services is appropriate even if the service is provided within the United States. Accordingly, the final regulations include an exception for property services performed with respect to property that is temporarily located in the United States and treats those services as being provided with respect to tangible property located outside the United States if several conditions are satisfied. See § 1.250(b)–5(g)(2). Those conditions are that the property must be temporarily located in the United States for the purpose of receiving the property service; after the completion of the service, the property will be primarily

hanged, docked, stored, or used outside the United States; the property is not used to generate revenue in the United States at any point during the duration of the service; and the property is owned by a foreign person that resides or primarily operates outside the United States.

E. Transportation Services

The proposed regulations provided that the provision of a transportation service is a FDDEI service if both the origin and the destination of the service are outside the United States. See proposed § 1.250(b)–5(h). Where either the origin or destination (but not both) are outside the United States, then 50 percent of the transportation service is considered a FDDEI service. The proposed regulations defined a transportation service as a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any similar mode of transportation. See proposed § 1.250(b)–5(c)(7).

Comments requested that the final regulations include elections with respect to cross-border transportation services, including an election for taxpayers to choose either (i) the 50-percent FDDEI treatment provided in the proposed regulations, or (ii) a bifurcation method under which the FDDEI treatment of income from the service is based on actual time or mileage, or (iii) a predominant location method in which all of the income from the service is FDDEI if the taxpayer can demonstrate that more than 50-percent of the services were provided to a person or with respect to property outside the United States on a mileage basis. A comment also requested clarification on whether intermediate domestic stops can be disregarded for purposes of determining the origin and destination of a transportation service.

The final regulations retain the rule in the proposed regulations. See § 1.250(b)–5(h). The Treasury Department and the IRS have determined that the primary benefit of the service relates to servicing the origin or destination market. A 50/50 allocation rule thus provides a simpler and more administrable rule for reflecting the value of each market when the origin or destination is in the United States. In addition, the Treasury Department and the IRS have determined that an elective rule that allows different taxpayers to choose the rule most favorable to their business models would result in inconsistent treatment of similarly situated taxpayers and lead to whipsaw for the IRS. In addition, the rule in the proposed regulations is clear that only the locations of the origin and destination, and not intermediate stops, are relevant to the determination. Accordingly, the final regulations do not adopt these comments. However, the final regulations clarify that freight forwarding and similar services are included within the definition of “transportation services.” See § 1.250(b)–5(c)(9).

IX. Comments on and Revisions to Proposed § 1.250(b)–6—Related Party Transactions

In the case of a sale of general property or a provision of a general service to a related party, proposed § 1.250(b)–6 provided additional requirements that must be satisfied for the transaction to qualify as a FDDEI sale or FDDEI service. These requirements must be satisfied in addition to the general requirements that apply to such sales and services as provided in proposed §§ 1.250(b)–3 through 1.250(b)–5.

A. Related Party Sales

1. Amended Return Requirement

The proposed regulations provided two distinct rules for determining whether a sale of property to a related party (related party sale) is a FDDEI transaction. One rule applied when the related party resells the purchased property in an unrelated party transaction, either without modification or where the related party incorporates the purchased property as a component of property that is then resold in an unrelated transaction. See proposed § 1.250(b)–6(c)(1)(i). A different rule applied when the related party uses the property in an unrelated transaction, either in connection with the sale of altogether different property or to provide a service. See proposed § 1.250(b)–6(c)(1)(ii).

The rule for resales in proposed § 1.250(b)–6(c)(1)(i) required that an unrelated party transaction actually occur before the taxpayer can treat the original sale to the related party as a FDDEI transaction. If an unrelated party transaction has not occurred by the filing date of the return that includes the original sale (FDII filing date), the taxpayer cannot immediately treat the original sale as a FDDEI transaction. Instead, in the subsequent year when the unrelated party transaction occurs, the taxpayer can file an amended return for the tax year of the original related party sale treating that sale as a FDDEI transaction and determine its modified FDII benefit accordingly, assuming the period of
limitations provided by section 6511 remains open when the unrelated party transaction occurs.

In contrast to the resale rule of proposed § 1.250(b)–6(c)(1)(i), where a related party uses the property in an unrelated party transaction (rather than resells that property), the taxpayer was permitted under proposed § 1.250(b)–6(c)(1)(ii) to treat that related party sale as a FDDEI transaction so long as the taxpayer reasonably expected, as of the FDII filing date, that one or more unrelated party transactions will occur with respect to the property sold to the related party and that more than 80 percent of the revenue earned by the foreign related party will be earned from such unrelated party transaction or transactions.

Several comments noted administrative difficulties with the amended return requirement for resale transactions in proposed § 1.250(b)–6(c)(1)(i). Many comments questioned the requirement of filing an amended return, arguing that it was administratively burdensome (for taxpayers, the IRS, and even state tax authorities) to file or process multiple amended returns. Some comments noted that because of long production or sales cycles, an unrelated party transaction will often not occur by the FDII filing date and might not occur until after the period of limitations under section 6511 has closed so taxpayers would no longer have the ability to treat the related party sale as a FDDEI transaction. Other comments observed that a taxpayer cannot always trace whether any particular sale to a related party leads to a particular unrelated party transaction given that taxpayers often sell products of a fungible nature or rely on accounting systems that track inventory flows broadly rather than specifically identifying transactions item by item. For such taxpayers, it would be impractical to require tracing, whether at the FDII filing date or any other time.

The preamble to the proposed regulations invited comments on the procedure for amending returns or suggestions for other alternatives for accounting for information relating to foreign use acquired only after the filing of a corporation’s original return. In response, several comments suggested allowing taxpayers to treat the sale to a related party as a FDDEI transaction in the year the related party sale occurred and, if an unrelated party transaction did not in fact occur in a later year, the taxpayer could adjust its FDDEI in that later year so that the FDII benefit it should not have claimed. Other comments responded with a range of other alternatives to the amended return requirement such as an election to defer the FDII benefit until the tax year of the unrelated party transaction or a carryforward mechanism for the amount of the original FDII benefit to the later year when the unrelated party transaction occurs (which would be based on the FDII that would have been available in the year of the related party sale and could either take the form of a deduction or a credit in the year of the unrelated transaction).

Some comments pointed out the different treatment of related party sales and the related party use rules of proposed § 1.250(b)–6(c)(1)(ii). Under the related party use rules, a taxpayer could treat a sale to a related party as a FDDEI transaction so long as the taxpayer reasonably expected that an unrelated party transaction would later occur, which would alleviate the administrative burdens of the amended return requirement. Under this approach, a taxpayer need not wait until the subsequent unrelated party transaction actually occurred to claim a FDII benefit in the year of the original sale. One comment noted that because the U.S. parent controls the process and all the sellers are related, the taxpayers would generally be in a position to know what products would be sold to foreign unrelated buyers for foreign use. Comments suggested similar treatment for both related party sales and related party use.

Comments further provided suggestions for how a taxpayer could demonstrate it had a reasonable expectation as of the FDII filing date that an unrelated party transaction would occur. Several comments requested that the ability to use market research such as inventory turnover, statistical sampling, economic modelling or other similar methods, with one comment suggesting that the fungible mass rule in proposed § 1.250(b)–4(d)(3)(iii) also be adopted in this context. One comment suggested that an unrelated party transaction exists whenever the product sold is specifically designed for a foreign market or can only be used outside of the United States. Another noted that in some cases the related party buyer is contractually obligated to sell products only to unrelated foreign parties. Comments also noted that past practice could inform the reasonable expectation of unrelated party transactions.

The Treasury Department and the IRS agree with the concerns expressed by the comments about the administrative burdens that the amended return requirement can cause for both taxpayers and tax administrators. Therefore, the final regulations modify the resale rule in proposed § 1.250(b)–6(c)(1)(i) to allow a taxpayer to treat a sale to a related party as a FDDEI transaction in the tax year of the related party sale provided that an unrelated party transaction has occurred or will occur in the ordinary course of business with respect to the property sold to the related party, whether the property is a completed product or a component of a different product. The unrelated party sale can occur at any time in the future so that taxpayers with long production or sales cycles are not unduly prevented from claiming FDII benefits based on the period of limitations for filing an amended return under section 6511. The condition that the unrelated party transaction must be in the ordinary course of business is intended to exclude situations in which the resale is tangential to the business of the taxpayer and related party (for example, if the taxpayer sells a machine to a related party for the related party’s consumption, and the machine is later sold by the related party for scrap or recycling).

The final regulations also remove the requirement that the FDII filing date is determinative with respect to related party sales and use of property in an unrelated party transaction. Taxpayers that engage in related party transactions should generally be able to obtain information after the FDII filing date that will confirm whether a related party sale is in fact a FDDEI sale or service. A rule that depends on the FDII filing date would create uncertainty during examinations if the FDII filing date is inconsistent with actual post-FDII filing date transactions. Therefore, if in fact, an unrelated party transaction does not actually occur in a future year, the related party sale would not be a FDDEI sale. This could also apply to related party services where a substantially similar service that occurs in a future year should be taken into account. See part IX.B.1. of this Summary of Comments and Explanation of Revisions section.

The final regulations also include guidance on how a taxpayer can demonstrate that an unrelated party sale will later occur. Taxpayers can rely on contractual restrictions or historical practices indicating that the related party only sells products to unrelated foreign customers. Moreover, if the design of a product indicates that it is destined only for foreign customers, taxpayers can establish that an unrelated party sale will occur with respect to that product.

In light of the more flexible approach to demonstrate that an unrelated party...
transaction will occur, the final regulations do not include a de minimis rule such as treating the entire fungible mass of sales as for a foreign use if a seller obtains documentation establishing that 90 percent or more of the fungible mass is for a foreign use (or conversely, no portion of the fungible mass is treated as for a foreign use if the seller does not obtain documentation establishing that 10 percent or more of the fungible mass is for a foreign use) as explained in part VII.C.4 of this Summary of Comments and Explanation of Revisions section.

2. Intermediate Sales to a U.S. Related Party Before Eventual Sale to an Unrelated Party

The proposed regulations provided that for purposes of determining whether a related party sale is for a foreign use, all foreign related parties of the seller are treated as if they were a single foreign related party. Proposed § 1.250(b)(6)(c)(3). This rule gave effect to section 250(b)(5)(C)(i)(I) (providing that a sale to a foreign related party may be for a foreign use if the property is ultimately sold by “a” foreign party to a foreign unrelated party) and allowed a sale to a foreign related party to be a FDDEI sale even if the property is resold to one or more other foreign related parties before the sale to an unrelated foreign person.

One comment requested that the final regulations clarify how the related party resale rule operates when the foreign related party buyer purchases a semi-finished product from the U.S. parent (or another domestic related party), finishes that product, and resells it to the U.S. parent (or another domestic related party) for ultimate sale to an unrelated person for a foreign use. The comment requested that the related party resale rule should apply notwithstanding the intermediate sale so long as the taxpayer can substantiate the ultimate sale of property to the unrelated foreign party. The comment argued that such a clarification would eliminate unwarranted disparate treatment for U.S. companies that engage in multiple related-party sales as compared to those that engage in just one step.

The Treasury Department and the IRS generally agree with this comment and have modified § 1.250(b)(6)(c)(3) to provide that a U.S. person (either the seller itself or another U.S. person that is a related party of the seller) is treated as part of a single foreign related party. This rule only applies for purposes of determining whether the related party sale is for a foreign use; it does not modify or eliminate the requirement that a seller must sell property to a foreign person for the sale to be a FDDEI sale. However, the Treasury Department and the IRS are concerned that U.S. persons that are members of the same modified affiliated group, but not members of a consolidated group, could use this rule to avoid the requirement that a sale be made to a foreign person by inserting a foreign person, such as a foreign partnership, as an intermediary in the sale from one U.S. person to another U.S. person. The Treasury Department and the IRS have determined that it would be inappropriate to use the related party sales rules to expand the types of sales that are eligible to be treated as FDDEI sales in this way. Therefore, the rule does not treat a U.S. person as related to the seller if the U.S. person is not related to the seller under the 80 percent or more standard for vote or value in section 1504(a). See § 1.250(b)(6)(c)(3).

3. Rule for Use of Property in an Unrelated Party Transaction

For transactions other than the resale of purchased property, such as where the foreign related party uses the purchased property to produce other property that is sold in unrelated party transactions, or where the foreign related party uses the property in the provision of a service in an unrelated party transaction, the proposed regulations provided that the sale of property does not qualify as a FDDEI sale unless, as of the FDII filing date, the seller reasonably expects that more than 80 percent 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 that are FDDEI transactions (determined without regard to the documentation requirements in § 1.250(b)–4 or § 1.250(b)–5). See proposed § 1.250(b)(6)(c)(1)(ii). One comment expressed concern with the 80 percent rule of the proposed regulations creating a cliff effect whereby a taxpayer would derive no FDII benefit if its revenues fell below this threshold. That comment suggested either lowering the threshold or replacing it with a sliding scale upon a certain minimum level of revenues. It also noted that it is unclear how revenue should be measured for purposes of this 80 percent rule, such as whether it should be based on the price of all sales to end user customers and whether it should just include sales to unrelated customers or also related party sales.

The Treasury Department and the IRS agree with the comment that the related party sale and related party use rules should have similar standards. To make this rule consistent with the standard in § 1.250(b)(6)(c)(1)(ii), the final regulations modify the rule to require that one or more unrelated party transactions occurs with respect to the property. The Treasury Department and the IRS expect that taxpayers have sufficient control over the supply chain involving controlled transactions to make this determination. In addition, to eliminate the potential cliff effect described in the comment, the final regulations remove the 80 percent rule and instead require the seller in the related party transaction to allocate the buyer’s revenues ratable between related and unrelated party transactions based on revenues reasonably expected to be earned as of the FDII filing date. The final regulations also adopt the suggested clarification that revenue should be measured for this purpose based on the price of all transactions with unrelated parties.

Other comments requested clarifications and relevant examples concerning the definition of a component under proposed § 1.250(b)–6(b)(5)(ii) and how a component can be distinguished from a sale of property for use in connection with property sold to an unrelated person under proposed § 1.250(b)–6(b)(5)(iii). Several comments noted that the preamble to the proposed regulations stated that the component rule of proposed § 1.250(b)–4(d)(2)(iii)(C) did not apply for purposes of determining what is a component for purposes of proposed § 1.250(b)–6(b)(5)(ii) and requested that this clarification be included in the text of the final regulations. In response to the comments, the final regulations remove the reference to “component” in § 1.250(b)–6(b)(5)(ii) and replace it with “constituent part” to avoid any implication that the component rule of § 1.250(b)–4(d)(1)(iii)(C) may apply. Further, the final regulations modify the rule for a related party use transaction in § 1.250(b)–6(b)(3)(iii) to clarify that it does not include transactions in which the purchased property is a constituent part of the product sold, to eliminate any potential overlap with § 1.250(b)–6(b)(5)(ii). Lastly, the final regulations modify the example in § 1.250(b)–6(c)(4) to clarify that property that is used in connection with a sale to an unrelated party means property that is not a constituent part of the product that is ultimately sold.

B. Related Party Services

1. In General

The proposed regulations generally provided that a provision of a general service to a business recipient that is a
related party qualifies as a FDDEI service only if the service is not substantially similar to a service provided by the related party to persons located within the United States. See proposed § 1.250(b)–6(d)(1). One comment noted that, unlike the related party sales rules, the related party services rules of proposed § 1.250(b)–6(d) did not specify whether the substantially similar service needs to be provided before the FDI filing date for the rule to apply. The comment recommended a rule that is consistent with the related party sales rules. It suggested that the final regulations provide that the service to the related party is treated as a FDDEI transaction in the year provided to the related party if the substantially similar service test was not implicated in that year, but that taxpayers should be required to amend that return to reverse the FDI benefit if a substantially similar service occurs in a later year.

As discussed in part IX.A.1 of this Summary of Comments and Explanation of Revisions section, the final regulations eliminate the amended return requirement for related party sales and allow such sales to be FDDEI sales as long as an unrelated party transaction will occur. Accordingly, the final regulations do not adopt the suggestion to treat a service as not being subject to the substantially similar service test as long as there is no substantially similar service in the year of the related party transaction. However, the Treasury Department and the IRS agree with the recommendation that the related party sales and services rules should be made consistent with respect to the timing element of the unrelated transaction. Therefore, the final regulations provide that a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been or will be provided by the related party to a person located within the United States. The fact that a substantially similar service will occur in a future year does not prevent that substantially similar service from being considered in the determination of whether a related party service is a FDDEI service.

2. Clarifications Related to Benefit and Price Tests

Under the proposed regulations, a service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the United States if the related party service (or “related party service”) is used by the related party to provide a service to a person located within the United States and either the “benefit test” of proposed § 1.250(b)–6(d)(2)(ii) or the “price test” of proposed § 1.250(b)–6(d)(2)(ii) is satisfied. The benefit test is satisfied if 60 percent or more of the benefits conferred by the related party service are to persons located within the United States. See proposed § 1.250(b)–6(d)(2)(ii). Under the price test, a service provided by a renderer to a related party is “substantially similar” to a service provided by the related party to a person located within the United States if the renderer’s service is used by the related party to provide a service to a person located within the United States and 60 percent or more of the price that persons located within the United States pay for the service provided by the related party is attributable to the renderer’s service. See proposed § 1.250(b)–6(d)(2)(ii).

One comment supported these bright line tests for substantially similar services as practicable but asserted it would be burdensome for taxpayers to have to apply both tests, and therefore requested that the final regulations only retain the price test, or alternatively should apply the tests conjunctively so that only if both tests are met is a service considered substantially similar to a service provided by a related party to a person in the United States.

The Treasury Department and the IRS have determined that these two tests consider distinct factors, both of which are relevant, and therefore the final regulations do not adopt the suggestion that the benefit test be eliminated or that the tests be made conjunctive. Both tests address concerns with “round tripping” arrangements where the provision of services primarily benefits persons within the United States, but a related party located outside the United States is interposed in order to qualify the initial transaction as a FDDEI transaction. While the two tests may overlap, they also serve different purposes and address different concerns. One example that implicates the benefit test is when a related party bundles its own services that provide minimal benefit to persons located outside the United States with other services that primarily benefit persons located within the United States. The price test addresses situations such as when a taxpayer provides a broad range of services to a related party located outside the United States but one component of the service is provided unchanged to persons located within the United States and this is reflected in the price charged to the US customer compared to the price charged to the related party. Consequently, in the absence of the price test, a related party service that satisfies the benefit test could qualify as a FDDEI transaction even if the related party service accounts for 60 percent or more of the total price charged to customers located within the United States. However, the final regulations clarify that the benefit test is met only if 60 percent or more of the benefits conferred by the related party service are directly used by the related party to confer benefits on consumers or business recipients within the United States. See § 1.250(b)–6(d)(2)(i). For example, if a business recipient located in the United States hires the related party to provide a consulting service, and the related party hires the taxpayer to perform research that is used by the related party in performing the consulting service, the related party will have directly used the taxpayer’s research in performing the consulting service for the business recipient located within the United States. Services provided to the related party that will only indirectly benefit the related party’s service recipients (generally, when the related party’s service recipients would not be willing to pay for the related party service) are not “substantially similar” to the services provided by the related party. See § 1.482–9(o)(3)(ii) for an explanation of indirect or remote benefits.

Proposed § 1.250(b)–6(d)(3) provided that for purposes of applying the price and benefit tests, the location of a consumer or business recipient with respect to a related party service is determined under the principles that apply to FDDEI services. One comment requested the addition of a clarifying sentence to proposed § 1.250(b)–6(d)(3) indicating that the benefits conferred and price paid for the related party service that is provided to persons located in the United States must be allocated based on the locations of the business recipients that benefit from these services provided by the related party. In response to this comment, the final regulations clarify that if the related party provides a service to a business recipient, the business recipient is treated as a person located within the United States to the extent that the service confers a benefit on the business recipient’s operations located within the United States. The price paid to the related party is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. See § 1.250(b)–6(d)(3)(i).
are to persons located in the United States and outside the United States, the price paid by the related party for the related party service is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party. See §1.250(b)–6(d)(3)(ii). In addition, the examples have been revised to clarify the application of the rules. See §1.250(b)–6(d)(4).

X. Comments on and Revisions to Proposed §1.962–1

Proposed §1.962–1(b)(1)(i) allowed individuals making an election under section 962 to take into account the deduction for GILTI under section 250. Specifically, proposed §1.962–1(b)(1)(i)(A)(2) provided that “taxable income” for purposes of section 962 includes GILTI inclusions, and proposed §1.962–1(b)(1)(i)(B)(3) specified that the section 250 deduction for GILTI is permitted as a deduction to arrive at “taxable income.” The final regulations retain these rules without change.

One comment noted that the reference to section 960(a)(1) in §1.962–1(b)(2) was obsolete after the revisions to section 960 made by the Act, and that the regulations lacked any reference to foreign tax credits with respect to GILTI inclusions. The Treasury Department and the IRS agree with this comment. Accordingly, §1.962–1(a)(2), (b)(2), and (c) have been updated to replace obsolete cross-references to section 960(a)(1) with cross-references to section 960(a); §1.962–1(b)(2) has been updated to clarify that foreign tax credits with respect to GILTI inclusions under section 960(d) are available to individuals making section 962 elections (subject to the limitations of section 904(c) and 904(d)(1)(A)); and §1.962–1(c) has been updated to provide a revised example illustrating the application of §1.962–1. The limitation on the section 11(c) surtax exemption (repealed in 1978)7 provided in §1.962–1(b)(1)(ii) has also been struck from §1.962–1.

Finally, the Treasury Department and the IRS understand that there is uncertainty regarding the situations in which individuals may make a section 962 election on an amended return. The Treasury Department and the IRS are considering issuing further guidance under section 962. Until further guidance on this issue is published, individuals may make an otherwise valid section 962 election on an amended return for the 2018 tax year and subsequent years, regardless of circumstance, provided the interests of the government are not prejudiced by the delay, as described in §301.9100–3(c). For example, the interests of the government could be prejudiced when a section 962 election is made on an amended return resulting in an overpayment in a year for which the period to file a claim for refund is open under section 6511 and simultaneously increasing the amount of U.S. tax due in years for which the assessment period under section 6501 has expired.

XI. Comments on and Revisions to Proposed §§1.1502–12, 1.1502–13, and 1.1502–50—Consolidated Section 250

Proposed §1.1502–50 provided that the section 250 deduction of a member of a consolidated group (member) is determined by reference to the relevant items of all members of the same consolidated group (single-entity treatment). Single-entity treatment ensures that the aggregate amount of section 250 deductions allowed to members appropriately reflects the income, expenses, gains, losses, and property of the consolidated group as a whole. To effectuate single-entity treatment, proposed §1.1502–50 aggregated the DEI, FDDEI, DITR, and GILTI of all members, the amounts of which are used to calculate an overall deduction amount for the consolidated group. See proposed §1.1502–50(e) (providing definitions). The aggregate deduction amount for the consolidated group is then allocated among the members on the basis of their respective contributions to consolidated FDDEI and consolidated GILTI. See proposed §1.1502–50(b).

A. Single-Entity Treatment

Two comments addressed the computation of a member’s section 250 deduction. The comments generally supported single-entity treatment. However, one comment recommended permitting a taxpayer to elect out of single-entity treatment with respect to the section 250 deduction attributable to GILTI. The comment expressed concern about applying the taxable income limitation in section 250(a)(2) to companies with pre-Act NOLs while also arguing that the NOLs of a consolidated group should not affect the section 250 deduction attributable to GILTI. The comment asserted that single-entity treatment could result in an inappropriate permanent disallowance of the section 250 deduction in a life-nonlife consolidated group if the allocation of the section 250 deduction among members is made on a subgroup basis. The comment recommended applying the section 250 deduction based on the life-nonlife consolidated group’s consolidated taxable income, rather than taking the deduction into account at the subgroup-level. Under the comment’s recommended approach, the section 250 deduction would be treated as a consolidated deduction to determine whether it can be used against consolidated taxable income before being allocated to a member. The Treasury Department and the IRS are studying these concerns and request comments on this topic.

C. Qualified Business Asset Investment

Proposed §1.1502–50(c)(1) provided that, for purposes of determining a member’s QBAI, the basis of specified tangible property does not include an amount equal to any gain or loss realized with respect to such property by another member in an intercompany transaction, whether or not such gain or loss is deferred. This rule was intended to negate the impact (whether positive or negative) of an intercompany sale of property on the computation of DII, in accordance with single-entity treatment. However, in most relevant cases, once an intercompany item has been included in income, there are real, external consequences to the group. For example, if gain has been included in consolidated taxable income (and in the tax system), the group should take the associated increase in tax basis into account. Therefore, these final regulations limit the application of the rule negating the impact of intercompany sales of property to the period during which the intercompany gain or loss remains deferred under §1.1502–13. See §1.1502–50(c)(1)(i).

The Treasury Department and the IRS are also concerned that single-entity treatment is not achieved in certain intercompany transactions involving the transfer of a partnership interest if such
transfers result in an increase or decrease in the basis of specified tangible property under section 743(b) and thus impact the computation of DII. The final regulations therefore provide that a member’s partner-specific QBAI basis includes a basis adjustment under section 743(b) resulting from an intercompany transaction only when, and to the extent, gain or loss, if any, is recognized in the transaction and no longer deferred under § 1.1502–13. See § 1.1502–50(c)(1)(ii).

XII. Applicability Dates

As proposed, proposed §§ 1.250(a)–1 through 1.250(b)–6 would apply to taxable years ending on or after March 4, 2019. However, the proposed regulations also provided that, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of the taxpayer’s business that establishes that a recipient is a foreign person, property is for a foreign use (within the meaning of proposed § 1.250(b)–4(d) and (e)), or a recipient of a general service is located outside the United States (within the meaning of proposed § 1.250(b)–5(d)(2) and (e)(2)), as applicable, in lieu of the documentation required in proposed §§ 1.250(b)–4(c)(2), (d)(3), and (e)(3) and 1.250(b)–5(d)(3) and (e)(3), provided that such documentation meets the reliability requirements described in proposed § 1.250(b)–3(d). The proposed regulations also provided that taxpayers may rely on proposed §§ 1.250(a)–1 through 1.250(b)–6 for taxable years ending before March 4, 2019.

The final regulations modify the applicability dates in proposed §§ 1.250(a)–1 through 1.250(b)–6 as follows. Except for § 1.250(b)–2(h), the rules in §§ 1.250(a)–1 through 1.250(b)–6 apply to taxable years beginning on or after January 1, 2021. Section 1.250(b)–2(h), which contains an anti-abuse rule for certain transfers of property, applies to taxable years ending on or after March 4, 2019, consistent with the applicability date in the proposed regulations. See, however, part V.C of this Summary of Comments and Explanation of Revisions section for a transition rule relating to transfers that occur before March 4, 2019.

However, taxpayers may choose to apply the final regulations to taxable years beginning before January 1, 2021, provided that they apply the final regulations in their entirety (other than the special substantiation requirements in § 1.250(b)–3(f) and the applicable provision of § 1.250(b)–4(d)(3) or § 1.250(b)–5(e)(4)). See section 7805(b)(7). Taxpayers will be required to substantiate under section 6001 that any sale or service qualifies for a section 250 deduction. Alternatively, taxpayers may rely on proposed §§ 1.250(a)–1 through 1.250(b)–6 in their entirety for taxable years beginning before January 1, 2021, except that taxpayers relying on the proposed regulations may rely on the transition rule for documentation for all taxable years beginning before January 1, 2021 (rather than only for taxable years beginning on or before March 4, 2019). See also part II of this Summary of Comments and Explanation of Revisions section.

Section 1.962–1(b)(1)(i)(B)(3), which allows individuals making an election under section 962 to take into account the section 250 deduction, applies to taxable years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Proposed § 1.962–1(b)(1)(i)(A)(2), which updates the regulations to conform to the enactment of section 951A by providing that “taxable income” for purposes of section 962 includes GILTI inclusions, is proposed to apply beginning with the last taxable year of a foreign corporation beginning before January 1, 2018, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends. The final regulations provide that § 1.962–1(b)(1)(i)(A)(2) applies to taxable years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

With respect to taxable years before the relevant final regulations are applicable, the final regulations provide that taxpayers may choose to apply the provisions of § 1.962–1(a)(2), (b)(1)(i)(A)(2), (b)(1)(i)(B)(3), (b)(1)(ii), (b)(2)(i) through (iii), and (c) for taxable years of a foreign corporation beginning on or after January 1, 2018, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Proposed § 1.1502–50 was proposed to apply to consolidated return years ending on or after April 15, 2020. The final regulations provide that § 1.1502–50 applies to consolidated return years beginning on or after January 1, 2021. Taxpayers that choose to apply the final regulations under §§ 1.250(a)–1 through 1.250(b)–6 to taxable years beginning before January 1, 2021, must also apply the provisions in § 1.1502–50 to such years. Similarly, taxpayers that rely on proposed §§ 1.250(a)–1 through 1.250(b)–6 for taxable years beginning before January 1, 2021, must also follow proposed § 1.1502–50.

Proposed §§ 1.6038–2(f)(15) and 1.6038A–2(b)(5)(iv) are proposed to apply with respect to information for annual accounting periods beginning on or after March 4, 2019. See sections 6038(a)(3) and 7805(b)(1)(B). Proposed § 1.6038–3(g)(4) is proposed to apply to taxable years of a foreign partnership beginning on or after March 4, 2019. See section 7805(b)(1)(B). No changes were made to the proposed applicability date in the final regulations.
attributable to U.S. activities that serve foreign markets and (2) a portion of profits of controlled foreign corporations ("CFCs"). The deduction has the effect of reducing the role that U.S. tax considerations play in a domestic corporation's decision about whether to service foreign markets directly or through a CFC, and also of protecting the U.S. tax base against base erosion incentives created by the new participation exemption system established under section 245A. 

At the most basic level, the section 250 deduction is available to domestic corporations with respect to their "excess return" (that is, their return in excess of a fixed return on tangible assets) derived from serving foreign markets. This deduction results in a lower effective rate of U.S. tax on the corporations' foreign-derived intangible income ("FDII") and global intangible low-taxed income ("GILTI"). FDII is the portion of the "excess return" derived from serving foreign markets directly from the United States, while GILTI is the portion of the "excess return" derived through foreign affiliates. FDII and GILTI are calculated based on formulas set out in sections 250 and 951A, respectively. For taxable years between 2018 and 2025, section 250 generally allows a deduction equal to the sum of 37.5 percent of the corporation's FDII plus 50 percent of its GILTI (hereafter, these deductions are reduced to 21.875 percent and 37.5 percent, respectively). These deduction rates are intended to produce comparable tax rates on income earned from serving foreign markets, regardless of whether such income is earned directly by a domestic corporation or by its CFCs. 

On March 6, 2019, the Treasury Department and the IRS published proposed regulations relating to section 250 ("proposed regulations").

B. Need for Final Regulations

Regulations are needed to aid taxpayers in determining the amount of their section 250 deduction. The final regulations are also needed to respond to comments received on the proposed regulations.

C. Baseline

The economic analysis that follows compares the final regulations to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of the final regulations. This no-action baseline reflects the current environment including the existing international tax regulations pursuant to the Act, prior to any amendment by the final regulations.

D. Economic Analysis

The final regulations provide certainty and clarity to taxpayers regarding the section 250 deduction. In the absence of such guidance, the chance that different taxpayers would interpret the statute differently would be exacerbated. Similarly situated taxpayers might interpret the statutory rules pertaining to the treatment of particular sales or services differently, with one taxpayer pursuing a sale that another taxpayer might decline to make because of different interpretations of how the income would be treated under section 250. If this second taxpayer's activity were more profitable, an economic loss is possible and such situations are more likely to arise in the absence of guidance. While no guidance can curtail all differential or inaccurate interpretations of the statute, the final regulations significantly mitigate the chance for differential or inaccurate interpretations and thereby increase economic efficiency.

The Treasury Department and the IRS expect that in the absence of this guidance taxpayers would undertake fewer eligible sales and services. Thus, the final regulations will generally enhance sales and services across certain eligible activities relative to the no-action baseline. Because of the scale of U.S. economic activity generally associated with foreign use (independent of any specific definition of foreign use) and because of the general responsiveness of economic activity to effective tax rates, which may be affected by the section 250 deduction, we project that the final regulations will have annual economic effects greater than $100 million (2020 dollars) relative to the no-action baseline.

The Treasury Department and the IRS have not made quantitative estimates of the effects of these final regulations on the volume of eligible sales and services or on the overall size or composition of U.S. economic activity relative to the no-action baseline or regulatory alternatives. The Treasury Department and the IRS have not undertaken these estimates because we do not have sufficiently detailed data or models for: The costs to taxpayers of establishing that particular transactions are eligible for the section 250 deduction.

---

3 See Senate Explanation, at 370 ("[O]ffering similar . . . rates for intangible income derived from markets, whether through U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.").

4 See Joint Comm. on Taxation, General Explanation of Public Law 115-97, at 377-383.
activities.10 No data derived from tax
the final regulations. This estimate is
 taxpayers may be potentially affected by
project that as many as 350,000
baseline and regulatory alternatives.
Each of these items would be needed to
provide sufficiently precise estimates of
the effects of these final regulations.
The Treasury Department and the IRS
project that as many as 350,000
taxpayers may be potentially affected
by the final regulations. This estimate is
based on International Trade
Administration (“ITA”) statistics of the
number of companies engaged in export
activities.10 No data derived from tax
forms were available to provide an
estimate of potentially affected
taxpayers because the section 250
deduction is new and the transactions
that would now give rise to a section
250 deduction were not previously
separately reported on tax forms. No
comments were received on estimates of
the number of affected taxpayers
provided in the proposed regulations.
The Treasury Department and the IRS
plan to include estimates of the number
of affected taxpayers in analysis of any
future regulatory guidance when possible.
The economic effects of major
provisions of these final regulations are
discussed qualitatively in Part LC and
are separately categorized depending on
whether the provisions have been
significantly revised from the proposed
regulations or are largely unchanged
from the proposed regulations.
The Treasury Department and the IRS
solicit comments on the economic
effects of the regulations.
1. Economic Effects of Provisions
Substantially Revised From the 2019
Section 250 Proposed Regulations
a. Documentation Requirements
The statute provides a section 250
deduction for certain income derived by
the taxpayer from serving foreign
markets but it does not provide detail
regarding what it means to “serve
foreign markets” or how to document
that fact. Many of the calculations
needed for the section 250 deduction
are based on Foreign Derived Deduction
Eligible Income (FDDEI), which is
certain income derived from sales of
property to foreign persons for “foreign
use” and from the provision of services
to persons, or with respect to property,
located outside the United States. The
statute is likewise silent on the meaning
of “foreign use.”
The proposed regulations defined
terms and prescribed specific
documents that taxpayers were required
to hold to establish that such income
was derived from serving foreign
markets. Comments to the proposed
regulations, however, noted that the
documentation requirements were
prohibitively burdensome because,
counter to the original understanding of
the Treasury Department and the IRS,
taxpayers frequently do not have ready
access to those types of documentation.
Therefore, comments argued, the
proposed regulations frequently created
compliance costs that were high relative
to the value of the deduction. In
addition, comments explained that for
taxpayers that enter into long term
contracts, it was difficult to
simultaneously satisfy the proposed
regulations’ requirements that the
documentation be obtained by the FDII
filing date and also that it be obtained
no earlier than one year before the date
of the sale or the service. Commenters
also noted that the Regulatory
Flexibility Act analysis for the proposed
regulations provide an estimate of the
compliance burden for small entities but
did not provide a comparable estimate
for larger entities, which could have had
a considerably higher burden.
Because of these difficulties, the
Treasury Department and the IRS adopt
a different approach in the final
regulations for the substantiation of
foreign use for purposes of the section
250 deduction. This approach is
described in sections 3.a.i–3.a.iii. For
each of the items in 3.a.i–3.a.iii, the
approach in the final regulations is
significantly more flexible than the
specific documentation requirements in
the proposed regulations.
The Treasury Department and the IRS
have determined that the substantiation
requirements in the final regulations
provide a reasonable balance of
compliance costs and the administrative
burden of ensuring that the transactions
are consistent with the intent and
purpose of the statute.
i. General Substantiation Versus
Specific Substantiation
The statute generally provides a
section 250 deduction for income that is
for foreign use and specifies that the
Secretary should issue regulations to
specify how foreign use should be
substantiated for purposes of tax
administration. To address the
substantiation issue, the Treasury
Department and the IRS considered:
(i) Which types of transactions should be
subject (only) to the general
substantiation rules that apply to all
deductions, versus requiring specific
substantiation, and (ii) for those
transactions for which more specific
substantiation will be required, what
forms specific substantiation should take.
The final regulations specify that for
many types of sales and services,
eligibility for the section 250 deduction
is subject only to the general
requirement under the Code that
eligibility for deductions must be
supported by sufficient substantiation,
including through the use of available
business records. The final regulations
provide substantiation requirements
that are generally similar to the
substantiation requirements for other
types of deductions, which helps
standardize deduction-related benefits
in the Code and thereby minimizes the
risk of unintended complications across
provisions of the Code.
The Treasury Department and the IRS
considered allowing general
substantiation for all types of
transactions. However, the Treasury
Department and the IRS determined that
certain types of transactions pose a
higher risk of being treated as eligible
transactions (FDDEI transactions)
without the taxpayer having generated
revenue from serving foreign markets.
For these certain transactions, the final
regulations provide specific
substantiation requirements. These
requirements involve either (i) a specific
document, (ii) information from the
recipient obtained or created in the
ordinary course of business, or (iii) a
taxpayer statement with corroborating
evidence (where the taxpayer chooses
the form of corroborating evidence).
In general, these requirements are
substantially more flexible than the
documentation requirements set forth in
the proposed regulations because they
allow taxpayers to choose the method of
substantiation among a set of options
and because this set includes options
that are less onerous than in the
proposed regulations. In addition, to
further reduce compliance burdens
relative to the proposed regulations, and
in response to comments, the final
regulations remove the requirement in
the proposed regulations that the
substantiating documents must be
obtained no earlier than one year before
the date of the sale or service.
The main categories of transactions for which specific substantiation is

10 ITA data was accessed at http://tse.export.gov/
EDB/SelectReports.aspx?DATA=ExporterDB in
December, 2016.
required are: (i) Sales of intangible property; (ii) sales of general property to resellers and manufacturers; and (iii) the provision of general services to business recipients. These types of transactions generally have a higher potential for mischaracterization than other transactions for which general substantiation is required; for example, intangible property is often used both within and without of the United States, and without some specific substantiation documenting its use, the foreign portion could easily be overstated. Similarly, if a U.S. person sells a finished good to a foreign reseller, the final regulations require the taxpayer to provide evidence that the reseller will not immediately sell the property back into the United States; otherwise, the taxpayer could claim the section 250 deduction for what is effectively a sale for domestic use. The Treasury Department and the IRS have determined that this latter activity would not be consistent with the intent and purpose of the statute. In addition, in the case of general services (such as consulting or accounting services) provided to a business recipient that is an integrated multinational company with operations within and outside the United States, without substantiation the IRS would have difficulty verifying the extent to which the business recipient’s operations outside the United States benefited from the service. Thus, the Treasury final regulations impose more thorough substantiation requirements for such types of transactions.

The specific substantiation requirements provide that a taxpayer may substantiate that a sale of general property to a distributor is for a foreign use by maintaining proof that property is specifically designed, labeled, or adapted for a foreign market or proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical that the property will be resold in the United States.

Furthermore, in recognition of the fact that statutory alternatives may not be able to substantiate their deductions with information already available to them, the specific substantiation requirements do not apply to taxpayer years beginning before January 1, 2021. In addition, the specific substantiation requirements do not apply to businesses with less than $25 million in gross receipts.

The Treasury Department and the IRS do not have readily available data or models to provide sufficiently precise estimates of the difference in compliance costs for these provisions between the final regulations and regulatory alternatives such as the proposed regulations.

ii. Removal of Specific References to Market Research

The proposed regulations contained specific rules regarding appropriate methods of documenting foreign use for: (i) Fungible mass property and (ii) general services provided to a business recipient located outside the United States. In particular, the proposed regulations provided that a seller could establish certain foreign use through market research, including statistical sampling, economic modeling and other similar methods. In light of the more flexible and less prescriptive approach to documentation generally taken by the final regulations relative to the proposed regulations, the Treasury Department and the IRS have determined that prescribing specific methods (such as market research) for determining the use of these types of property is not necessary and have further determined that general market research based on secondary sources could be misleading in this circumstance.

The Treasury Department and the IRS do not have readily available data or models to provide sufficiently precise estimates of the difference in compliance costs for these items between the final regulations and regulatory alternatives such as the proposed regulations.

iii. Digital Content, Electronically Supplied Services, and Advertising Services

The final regulations also clarify how to establish foreign use for sales of digital content and how to establish a recipient’s location outside the United States with respect to electronically supplied services and advertising services. As noted in comments, the proposed regulations did not clearly explain how foreign use should be established for transfers of copyrighted articles that are delivered electronically rather than on a physical medium. To clarify the treatment of these sales, the final regulations specify that a sale of a copyrighted article is evaluated under the general property rules rather than the rules for foreign use of intangible property regardless of how the copyrighted article is transferred. In addition, the final regulations provide new rules for establishing whether a sale of digital content, which may include a sale of a copyrighted article, is for a foreign use. The final regulations define “digitally content” as a computer program or any other content in digital format. A sale of
structured (pursuant to the Arms Export Control Act) as sales and services provided to the U.S. government. The equipment or services are then sold or provided by the U.S. government to the foreign government; in effect, the contractor is selling goods and services to a foreign person but the sale is technically made to the U.S. government. The Treasury Department and the IRS recognize that the statute is unclear as to whether such sales and services can qualify for the section 250 deduction.

The Treasury Department and the IRS considered several options for treating these sales and services. One option was not addressing this issue in the final regulations. This option was rejected because the Treasury Department and the IRS determined that it would perpetuate uncertainty about the application of section 250 to foreign military sales and services made through the U.S. government and could thus result in inefficient economic activity if some taxpayers took the position that these sales and services qualify for a section 250 deduction but other similarly-situated taxpayers took the position that they do not qualify. Furthermore, to the extent that some taxpayers took the position that these sales and services do not qualify, their economic decisions would be inefficient when evaluated under the intent and purpose of the statute.

A second option was to clarify that a foreign military sale or service through the U.S. government does not qualify for a section 250 deduction. This option was rejected because the Treasury Department and the IRS determined that this treatment would be inconsistent with the intent and purpose of the statute, and thus economic activity would be inefficient when evaluated under this standard.\(^\text{11}\)

A third option was to allow any sale or service to a U.S. person that acts as an intermediary and does not take on the benefits and burdens of ownership to generally qualify for a section 250 deduction if there is an ultimate foreign recipient. This option was rejected because the Treasury Department and the IRS determined that such a broad exception could allow multiple section 250 deductions for the same transaction if both the seller and the intermediary buyer were U.S. taxpayers. Furthermore, determining whether a party is an “intermediary” for this purpose would require a complex facts-and-circumstances analysis of whether the party had the benefits and burdens of ownership.

A fourth option was the approach adopted in the proposed regulations, which provided that sales of property or the provision of a service to the U.S. government under the Arms Export Control Act is treated as a sale of property or provision of a service to a foreign government and thus generally eligible for the section 250 deduction. The final regulations adopt the approach provided in the proposed regulations but relax the proposed regulations’ documentation requirements. Instead, under the final regulations only the general substantiation requirements apply to these transactions. Thus, the final regulations provide that foreign military sales or services to the U.S. government under the Arms Export Control Act are treated as an eligible sale or service. This rule provides uniform tax treatment between the defense sector and other sectors of the U.S. economy with respect to services that are clearly meant for a foreign use. The final rule also results in lower compliance costs than the proposed regulations because it requires no further substantiation beyond compliance with the Arms Export Control Act rules.

The Treasury Department projects that this reduction in compliance costs will increase foreign military sales and services. The Treasury Department and the IRS have not estimated either the reduction in compliance costs under the final regulations relative to the no-reduction action baseline or regulatory alternatives including the proposed regulations or the change in foreign military sales and services that would result from this reduction. They have not undertaken this estimation because they do not have sufficiently detailed data or models of the costs to taxpayers of establishing that particular transactions are eligible for the section 250 deduction, or the responsiveness of such transactions to compliance costs.

c. Additional Issues and Changes

The final regulations contain several additional changes that will generally expand the situations in which a transaction will be a FDDEI transaction relative to the proposed regulations. The final regulations add an exception to the rule in the proposed regulations that a property service is a FDDEI service only if the property is located outside the United States for the duration of the period the service is performed. The exception provides that a property service may be a FDDEI service if it is provided with respect to property that is temporarily located in the United States. This will increase the number of property services that constitute FDDEI services relative to the proposed regulations. The final regulations also clarify that the toll manufacturing services are treated as property services. Because of the new exception for property services with respect to property temporarily in the United States, this clarification should increase the number of toll manufacturing and repair, maintenance, and overhaul services that will constitute FDDEI services relative to the proposed regulations. This rule will also mitigate incentives to restructure service contracts into sale contracts (for example by having the property owner sell and buy back the property that requires service) in order to qualify for FDII benefits despite the lack of any economic efficiency gains from doing so. The Treasury Department and the IRS have not estimated the effect of these changes on compliance costs or on the volume of property services or specifically toll manufacturing services that U.S. businesses may undertake relative to the proposed regulations.

The final regulations revise the definition of transportation services to include freight forwarding services because such services are economically similar to the types of shipping services that are already described in the definition of transportation services; this will provide greater certainty to taxpayers that provide these services because the test for determining whether a transportation service is a FDDEI service (based on the origin and destination of the service) will generally be clearer than the test for general services (based on the location of the recipient). The Treasury Department and the IRS have not estimated the effect of this clarification on compliance costs or on the volume of freight forwarding services that U.S. businesses may undertake relative to the proposed regulations.

The final regulations add an exception to the general rule in the proposed regulations that intangible property used in manufacturing is treated as for a foreign use outside the United States only to the extent that the end users of the manufactured property are located outside the United States. The exception allows that a sale of a manufacturing method or process intangible to a foreign unrelated party is for foreign use based on the location of manufacture rather than the location of the ultimate end user. This provides a meaningful reduction in compliance burden relative to the proposed regulations because it does not require

\(^{11}\) See Joint Comm. on Taxation, General Explanation of Public Law 115–97, at, at 380 n. 1740.
the seller to track the product to its end user and instead relies on information immediately knowable to the seller. The Treasury Department and the IRS have not estimated the effect of this exception on compliance costs or more generally on U.S. economic activity relative to the proposed regulations because we do not have sufficiently precise data on the number of potentially affected taxpayers or the volume of affected activity.

The final regulations eliminate the requirement in the proposed regulations that for sales of international transportation property to be eligible for the section 250 deduction, the property must be located outside the country more than 50 percent of the time and used outside the country for more than 50 percent of the miles for the three-year period after delivery. In the final regulations, the sale of international transportation property is defined to be for a foreign use depending on where it is registered (and in the case of international transportation property not used for compensation or hire, also taking into account where it is primarily hangared or stored). This change in the definition eases the burden of compliance relative to the proposed regulations. The Treasury Department and the IRS have not undertaken quantitative estimates of the effect of this change on compliance costs or on sales of transportation property relative to the proposed regulations.

In response to comments, the final regulations clarify that the definition of general property includes physical commodities that are sold pursuant to derivative contracts. This revision addresses a concern raised in comments that some physical commodities may be sold pursuant to a forward or option contract that itself would not be general property. Also in response to comments, the final regulations provide that the amount of a taxpayer’s income from a transaction that is eligible for the section 250 deduction is increased by any gain, or decreased by any loss, taken into account with respect to certain derivative transactions. This revision reflects the owner’s gain from selling the branch (which generally reflects business activity of the branch) versus income derived by the branch owner from the branch (which generally reflects the owner’s gain from appreciation in value of the branch), and will allow more transactions to qualify as FDDEI transactions. The Treasury Department and the IRS have not estimated the effects of this change relative to the proposed regulations.

d. Ordering Rule

The Act introduced multiple Code provisions that simultaneously limit the availability of a deduction based, directly or indirectly, upon a taxpayer’s taxable income. Because the deductions themselves affect taxable income, the order in which taxpayers calculate deduction limitations matters. The proposed regulations contained an example outlining a possible approach to an ordering rule for these Code provisions. Several comments suggested alternative ordering rules. The Treasury Department and the IRS have decided to further study the most appropriate ordering rule for computations across various provisions that are based upon a taxpayer’s taxable income. Therefore, the example from the proposed regulations has been removed and the Treasury Department and the IRS reserve on a final determination of the ordering rule at this time. For now, taxpayers can generally use any reasonable method to determine the ordering of rules that limit deductions based upon taxable income. Because we have decided to study this issue further, we have not yet estimated the economic effects of different potential ordering rules.

2. Economic Effects of Provisions Not Substantially Revised From the 2019 Section 250 Proposed Regulations

a. Computation of the Ratio of FDDEI to DEI

The Act defines a corporation’s FDII based on a set of calculations that includes the ratio of its FDDEI to its Deduction Eligible Income (“foreign-derived ratio”). The final regulations specify that, for purposes of determining the numerator of the foreign-derived ratio, the domestic corporation must allocate expenses to its gross FDDEI. The Treasury Department and the IRS deemed this approach the most consistent with the statute by providing what the Treasury Department and the IRS have determined to be the most accurate measure of the corporation’s income that is “foreign-derived,” through matching of expenses to gross income. In addition, the use of existing expense allocation rules potentially reduces the burden on taxpayers and the IRS relative to adopting a new set of expense allocation rules.

The Treasury Department and the IRS considered two other approaches; one, in which the foreign-derived ratio would be computed as the ratio of foreign versus U.S. gross receipts and another in which the ratio would be computed as foreign versus U.S. gross income. The Treasury Department and the IRS have determined that both of these approaches would result in a less accurate measure of foreign-derived net income. The Treasury Department and the IRS have determined that these alternative approaches could also reward low margin (or even loss-leading) sales or services to foreign markets by allowing a section 250 deduction due to positive gross receipts or income from foreign sources even if the net income from foreign sources after allocated expenses is zero or negative.

The Treasury Department and the IRS have determined that the chosen alternative generally provides the most accurate computation of FDII. We have not estimated the economic effects of including these alternative, less accurate computations of FDII in the calculation of taxpayers’ foreign-derived ratios.

b. Section 962

The section 250 deduction for FDII and GILTI is available only to domestic corporations. However, Congress enacted section 962 in Public Law 89–834 (1962) to ensure that individuals’ tax burdens with respect to undistributed foreign earnings of their CFCs are comparable with their tax burdens if they had held their CFCs through a domestic corporation. See S. Rept. 1881, 87th Cong., 2d Sess. 92 (1962).

To address this divergence, the Treasury Department and the IRS considered two options with respect to extending the section 250 deduction to individuals (which include, for this purpose, individual partners in partnerships and individual shareholders in S corporations) that make an election under section 962. The first option was to not allow the deduction for individuals. Not allowing the section 250 deduction would require that individuals that currently own their CFCs (directly or indirectly through a partnership or S corporation) transfer the stock of their CFCs to new U.S.
corporations in order to obtain the benefit of the section 250 deduction. The Treasury Department and the IRS determined that such reorganization would be economically costly, both in terms of legal fees and substantive economic costs related to organizing and operating new corporate entities with no general economic benefit relative to the second option.

The second option was to allow individuals to claim a section 250 deduction with respect to their GILTI if they make the section 962 election. The Treasury Department and the IRS determined that allowing individuals the section 250 deduction would improve economic efficiency by preventing the need for costly legal restructuring solely for the purpose of tax savings. Allowing a section 250 deduction with respect to GILTI of an individual (including an individual that is a shareholder of an S corporation or a partner in a partnership) that makes an election under section 962 provides comparable treatment for this income.

This is the option adopted by the Treasury Department and the IRS in the final regulations.

The Treasury Department and the IRS have not estimated the difference in economic effects between these two regulatory alternatives.

II. Paperwork Reduction Act

The regulations provide the authority for the IRS to require taxpayers to file certain forms with the IRS to obtain the benefit of the section 250 deduction. Pursuant to the regulations, all taxpayers with a section 250 deduction are required to file one new form (Form 8993). The regulations also authorize the IRS to request additional information on several existing forms (Forms 1065 (Schedule K–1), 5471, 5472, 8865, and other forms as needed) if the filer of the form has a deduction under section 250. In 2018, the IRS released and invited comments on drafts of these forms in order to give members of the public an opportunity to submit comments. The IRS received no comments on the portions of the forms that relate to section 250 during the comment period. Consequently, the IRS made the forms available in late 2018 for use by the public.

The information collection burdens under the Paperwork Reduction Act, 44 U.S.C. 3501 et seq. ("PRA") from these final regulations are in §§ 1.250(a–1)(d), 1.250(b–1)(e)(2), 1.6038–2(f)(15), 1.6038–3(g)(4), and 1.6038A–2(b)(5)(iv). For purposes of the PRA, the reporting burden associated with these collections of information will be reflected in the PRA submission for Form 8993, Form 1065, Form 5471, Form 8865, and Form 5472 (see chart at the end of this part II for OMB control numbers).

The tax forms that were created or revised as a result of the information collections in these final regulations, as well as the estimated number of respondents, are as follows:

### Related New or Revised Tax Forms

<table>
<thead>
<tr>
<th>Form</th>
<th>New</th>
<th>Revision of existing form</th>
<th>Number of respondents (estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>8993</td>
<td>✓</td>
<td></td>
<td>75,000–350,000</td>
</tr>
<tr>
<td>1065, Schedule K–1</td>
<td>✓</td>
<td>✓</td>
<td>15,000–45,000</td>
</tr>
<tr>
<td>5471</td>
<td>✓</td>
<td></td>
<td>10,000–20,000</td>
</tr>
<tr>
<td>8865</td>
<td>✓</td>
<td></td>
<td>&lt;10,000</td>
</tr>
<tr>
<td>5472</td>
<td>✓</td>
<td></td>
<td>50,000–80,000</td>
</tr>
</tbody>
</table>

Source: RAAS:CDW and ITA.

The numbers of respondents in the Related New or Revised Tax Forms table were estimated by the Research, Applied Analytics and Statistics Division ("RAAS") of the IRS from the Compliance Data Warehouse ("CDW"), using tax years 2014 through 2017; as well as based on export data from the International Trade Administration ("ITTA") for 2015 and 2016. Tax data for 2018 are not yet available due to extended filing dates. Data for Form 8993 represent preliminary estimates of the total number of taxpayers that may be required to file the new Form 8993. Data for each of the Forms 1065, 5471, 5472, and 8865 represent preliminary estimates of the total number of taxpayers that are expected to file these revised forms regardless of whether that taxpayer must also file Form 8993.

The current status of the PRA submissions related to the tax forms that will be revised as a result of the information collections in the section 250 regulations is provided in the accompanying table. The reporting burdens associated with the information collections in the regulations are included in the aggregated burden estimates for OMB control numbers 1545–0123 (which represents a total estimated burden time for all forms and schedules for corporations of 3.344 billion hours and total estimated monetized costs of $61.558 billion ($2019)), 1545–0074 (which represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.717 billion hours and total estimated monetized costs of $33.267 billion ($2019)), and 1545–1668 (which represents a total estimated burden time for all related forms and schedules for other filers, in particular trusts and estates, of 281,974 hours and total estimated monetized costs of $25.107 million ($2018)). The overall burden estimates provided for the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not relate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in the regulations. These numbers are therefore unrelated to the calculations needed to assess the burden imposed by the regulations. These burdens have been reported for other regulations related to the taxation of cross-border income and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overestimating the burden of the international tax provisions.

No burden estimates specific to the forms affected by the regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the regulations. The Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates would capture both changes made by the Act and those that arise out of discretionary authority exercised in the final regulations.

The Treasury Department and the IRS request comments on all aspects of
III. Regulatory Flexibility Act

It is hereby certified that this final regulation will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). The Treasury Department and the IRS have determined that the regulations may affect a substantial number of small entities, but have also concluded that the economic impact on small entities as a result of the collections of information in this regulation is not expected to be significant.

The small business entities that are subject to section 250 and these final regulations are small domestic corporations claiming a deduction under section 250 based on their FDII and GILTI. Pursuant to § 1.250(a)–1(d), taxpayers are required to file new Form 8993 to compute the amount of the eligible deduction for FDII and GILTI under section 250. The Treasury Department and the IRS estimate that there are between 75,000 and 350,000 respondents of all sizes that are likely to file Form 8993. Additionally, under § 1.250(b)–1(e), a partnership that has one or more direct or indirect partners that are domestic corporations and that is required to file a return under section 6031 must furnish on Schedule K–1 (Form 1065) certain information that would allow the partner to accurately calculate its FDII. The Treasury Department and the IRS estimate the number of domestic corporations that are direct or indirect partners in a partnership affected by § 1.250(b)–1(e) is between 15,000 and 45,000.

As discussed in the Summary of Comments and Explanation of Revisions section of this preamble, the Treasury Department and the IRS have determined that requiring specific documentation in every case is challenging given the variations in industry practices. Accordingly, the final regulations adopt a more flexible approach to the documentation requirements in the proposed regulations and, for certain of these regulatory requirements, instead provide substantiation rules that are more flexible with respect to the types of corroborating evidence that may be used to determine that a transaction is a FDDEI transaction. A transaction is a FDDEI transaction only if the taxpayer...
substantiates its determination of foreign use (in the case of sales of general property to non-end users and sales of intangible property) or location outside the United States (in the case of general services provided to a business recipient) as described in the applicable paragraph of §1.250(b)–4(d)(3) or §1.250(b)–5(e)(4). Similar to the exception for small businesses from the documentation requirements in the proposed regulations, the final regulations provide that the new specific substantiation requirements do not apply to a taxpayer if the taxpayer and all related parties of the taxpayer received less than $25,000,000 in gross receipts in the prior taxable year. The Treasury Department and the IRS anticipate that a substantial share of small entities claiming a section 250 deduction will qualify for the small business exception, thereby significantly reducing the overall burden of the final regulations on small entities. Although the rule will alleviate burden on many small entities, the Small Business Administration’s small business size standards (13 CFR part 121) identify as small entities several industries with annual revenues above $25 million.

For the rules in the final regulations for which there are no specific substantiation requirements, taxpayers will continue to be required to substantiate deductions under section 250 pursuant to section 6001. Small business entities are expected to experience 0 to 5 minutes, with an average of 2.5 minutes, of recordkeeping per transaction recipient. The hourly estimates include all associated activities: Recordkeeping, tax planning, learning about the law, gathering tax materials, form completion and submissions, and time with a tax preparer or use of tax software. The estimated monetized burden for small business entities for compliance is $33.12 per hour, a figure computed from the IRS Business Taxpayer Burden model which assigns each firm in the micro data a monetization rate based on total revenue and assets reported on their tax return. See “Tax Compliance Burden” (John Guyton et al., July 2018) at https://www.irs.gov/pub/irs-soi/d13315.pdf. The assigned monetization rates include, in addition to wages, employer non-wage costs such as employment taxes, benefits, and overhead. The reporting burden for completing Form 8993 is estimated to average 21 hours for all affected entities, regardless of size. The reporting burden on small entities (those with receipts below $25 million in RAAS calculations) is estimated to average 17.1 hours. Based on the monetized hourly burden reported above, the annual per-entity reporting burden for small entities will be $908.

For these reasons, the Treasury Department and the IRS have determined that the requirements in §§1.250(a)–1(d), 1.250(b)–4(d)(3), and 1.250(b)–5(e)(4) will not have a significant economic impact on a substantial number of small entities. The small business entities that are subject to §1.6038–2(f)(15), §1.6038–3(g)(4), or §1.6038A–2(b)(5)(iv) are domestic small business entities that claim a deduction under section 250 by reason of having FDII that are either controlling U.S. shareholders of a foreign corporation, controlling fifty-percent partners or controlling ten-percent partners of a foreign partnership, or at least 25-percent foreign-owned, by vote or value, respectively. The data to assess the number of small entities potentially affected by §§1.6038–2(f)(15), §1.6038–3(g)(4), or §1.6038A–2(b)(5)(iv) are not readily available. However, businesses that are controlling U.S. shareholders of a foreign corporation, controlling fifty-percent partners or controlling ten-percent partners of a foreign partnership, or at least 25-percent foreign-owned, by vote or value are generally not small businesses for the reasons described in part III of the Special Analyses section in the proposed regulation (REG–104464–18, 84 FR 6188 [March 6, 2019]).

Consequently, the Treasury Department and the IRS have determined that §§1.6038–2(f)(15), 1.6038–3(g)(4), and 1.6038A–2(b)(5)(iv) will not have a significant economic impact on a substantial number of small entities. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of OMB has determined that this Treasury decision is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.) (“CRA”). Under section 801(a)(3) of the CRA, a major rule generally may not take effect until 60 days after the rule is published in the Federal Register. Accordingly, the Treasury Department and IRS are adopting these final regulations with the delayed effective date generally prescribed under the Congressional Review Act.

Drafting Information

The principal authors of the regulations are Kenneth Jeruchim, Brad McCormack, and Lorraine Rodriguez of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in the development of the regulations.

Statement of Availability of IRS Documents


List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:
PART 1—INCOME TAXES

§ 1.250–0 Table of contents.

This section contains a listing of the headings for §§ 1.250–1, 1.250(a)–1, and 1.250(b)–1 through 1.250(b)–6.

§ 1.250–1 Introduction.

(a) Overview.

(b) Applicability dates.

§ 1.250(a)–1 Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).

(a) Scope.

(b) Allowance of deduction.

(1) In general.

(2) Taxable income limitation.

(3) Reduction in deduction for taxable years after 2025.

(4) Treatment under section 4940.

(c) Definitions.

(1) Controlled foreign corporation.

(2) Deduction eligible income.

(3) Deemed intangible income.

(4) Deemed tangible income return.

(5) Dividend.

(6) Domestic corporation.

(7) Domestic oil and gas extraction income.

(8) FDII filing date.

(9) FDII service.

(10) FDII transaction.

(11) Foreign branch income.

(12) Foreign-derived deduction eligible income.

(13) Foreign-derived ratio.

(14) Gross DEI.

(15) Gross DEII.

(16) Gross FDII.

(17) Modified affiliated group.

(i) In general.

(ii) Special rule for noncorporate entities.

(iii) Definition of control.

(iv) Qualified business asset investment.

(18) Related party.

(19) United States shareholder.

(d) Treatment of cost of goods sold and allocation and apportionment of deductions.

(1) Cost of goods sold for determining gross DEII and gross FDDEI.

(2) Deductions properly allocable to gross DEII and gross FDDEI.

(i) In general.

(ii) Determination of deductions to allocate.

(3) Examples.

(e) Domestic corporate partners.

(1) In general.

(2) Reporting requirement for partnership with domestic corporate partners.

(3) Examples.

(f) Determination of FDII for consolidated groups.

(g) Determination of FDII for tax-exempt groups.

§ 1.250(b)–2 Qualified business asset investment (QBAI).

(a) Scope.

(b) Definition of qualified business asset investment.

(c) Specified tangible property.

(1) In general.

(2) Tangible property.

(d) Dual use property.

(1) In general.

(2) Definition of dual use property.

(3) Dual use ratio.

(4) Example.

(e) Determination of adjusted basis of specified tangible property.

(1) In general.

(2) Effect of change in law.

(3) Specified tangible property placed in service before enactment of section 250.

(f) Special rules for short taxable years.

(1) In general.

(2) Determination of when the quarter closes.

(3) Reduction of qualified business asset investment.

(4) Example.

(g) Partnership property.

(1) In general.

(2) Determination of partnership QBAI.

(3) Determination of partner adjusted basis.

(i) In general.

(ii) Sole use partnership property.

(A) In general.

(B) Definition of sole use partnership property.

(iii) Dual use partnership property.

(A) In general.

(B) Definition of dual use partnership property.

(4) Determination of proportionate share of the partnership’s adjusted basis in partnership specified tangible property.

(i) In general.

(ii) Proportionate share ratio.

(5) Definition of partnership specified tangible property.

(6) Determination of partnership adjusted basis.

(7) Determination of partner-specific QBAI basis.

(8) Examples.

(h) Anti-avoidance rule for certain transfers of property.

(1) In general.

(2) Rule for structured arrangements.

(3) Per se rules for certain transactions.

(4) Definitions related to anti-avoidance rule.

(1) Disqualified period.

(ii) FDII-eligible related party.

(iii) Specified related party.

(iv) Transfer.


(6) Examples.

§ 1.250(b)–3 Foreign-derived deduction eligible income (FDDEI) transactions.

(a) Scope.

(b) Definitions.

(1) Digital content.

(2) End user.

(3) FDII filing date.

(4) Finished goods.

(5) Foreign person.

(6) Foreign related party.

(7) Foreign retail sale.

(8) Foreign unrelated party.

(9) Fungible mass of general property.

(10) General property.

(11) Intangible property.

(12) International transportation property.

(13) IP address.

Authority: 26 U.S.C. 7805 * * * * *
(14) Recipient.
(15) Renderer.
(16) Sale.
(17) Seller.
(18) United States.
(19) United States person.
(20) United States territory.
(c) Foreign military sales and services.
(d) Transactions with multiple elements.
(e) Treatment of partnerships.
(f) Substantiation for certain FDDEI transactions.
(i) In general.
(ii) Exception for small businesses.
(iii) Treatment of certain loss transactions.
(iv) Examples.
(v) Reason to know.
(A) Sales to a foreign person for a foreign use.
(B) General services provided to a business recipient located outside the United States.
(iii) Multiple transactions.
(iv) Example.
§ 1.250(b)–4 Foreign-derived deduction eligible income (FDDEI) sales.
(a) Scope.
(b) Definition of FDDEI sale.
(c) Presumption of foreign person status.
(i) In general.
(ii) Substantiation of foreign use.
(iii) Sales of property subject to a physical and material change.
(iv) Sales of property subject to a physical and material change.
(C) Property incorporated into a product as a component.
(iv) Sales of property subject to manufacturing, assembly, or other processing in the United States.
(v) Examples.
(ii) Foreign use for intangible property.
(i) In general.
(ii) Determination of end users and revenue earned from end users.
(A) Intangible property embedded in general property or used in connection with the sale of general property.
(B) Intangible property used in providing a service.
(C) Intangible property consisting of a manufacturing method or process.
(1) In general.
(2) Exception for certain manufacturing arrangements.
(3) Manufacturing method or process.
(D) Intangible property used in research and development.
(iii) Determination of revenue for periodic payments versus lump sums.
(A) Sales in exchange for periodic payments.
(B) Sales in exchange for a lump sum.
(C) Sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process.
(iv) Examples.
(3) Foreign use substantiation for certain sales of property.
(i) In general.
(ii) Substantiation of foreign use for resale.
(iii) Substantiation of foreign use for manufacturing, assembly, or other processing outside the United States.
(iv) Substantiation of foreign use of intangible property.
(v) Examples.
(e) Sales of interests in a disregarded entity.
(f) FDDEI sales hedging transactions.
(1) In general.
(2) FDDEI sales hedging transaction.
§ 1.250(b)–5 Foreign-derived deduction eligible income (FDDEI) services.
(a) Scope.
(b) Definition of FDDEI service.
(c) Definitions.
(1) Advertising service.
(2) Benefit.
(3) Business recipient.
(4) Consumer.
(5) Electronically supplied service.
(6) General service.
(7) Property service.
(8) Proximate service.
(9) Transportation service.
(d) General services provided to business recipients.
(1) In general.
(2) Electronically supplied services.
(3) Example.
(e) General services provided to business recipients.
(1) In general.
(2) Determination of business operations that benefit from the service.
(i) In general.
(ii) Advertising services.
(iii) Electronically supplied services.
(3) Identification of business recipient’s operations.
(i) In general.
(ii) Advertising services and electronically supplied services.
(3) No office or fixed place of business.
(4) Substantiation of the location of a business recipient’s operations outside the United States.
(5) Examples.
(f) FDDEI sales hedging transactions.
(1) In general.
(2) Exception for service provided with respect to property temporarily in the United States.
(h) Transportation services.
§ 1.250(b)–6 Related party transactions.
(a) Scope.
(b) Definitions.
(1) Related party sale.
(2) Related party service.
(c) Related party transactions.
(d) Related party services.
(1) In general.
(i) Use of property in an unrelated party transaction.
(2) Treatment of foreign related party as seller or renderer.
(3) Transactions between related parties.
(4) Example.
(d) Related party services.
(1) In general.
(2) Substantially similar services.
(3) Special rules.
(i) Rules for determining the location of and price paid by recipients of a service provided by a related party.
(ii) Rules for allocating the benefits provided by and priced paid to the renderer of a related service.
(4) Examples.
§ 1.250–1 Introduction.
(a) Overview. Sections 1.250(a)–1 and 1.250(b)–1 through 1.250(b)–6 provide rules to determine a domestic corporation’s section 250 deduction. Section 1.250(a)–1 provides rules to determine the amount of a domestic corporation’s deduction for foreign-derived intangible income and global intangible low-taxed income. Section 1.250(b)–1 provides general rules and definitions regarding the computation of foreign-derived intangible income. Section 1.250(b)–2 provides rules for determining a domestic corporation’s qualified business asset investment. Section 1.250(b)–3 provides general rules and definitions regarding the determination of gross foreign-derived deduction eligible income. Section 1.250(b)–4 provides rules regarding the determination of gross foreign-derived deduction eligible income from the sale of property. Section 1.250(b)–5 provides rules regarding the determination of gross foreign-derived deduction eligible income from the provision of a service. Section 1.250(b)–6 provides rules regarding the sale of property or provision of a service to a related party.
(b) Applicability dates. Except as provided in the next sentence, §§ 1.250(a)–1 and 1.250(b)–1 through 1.250(b)–6 apply to taxable years beginning on or after January 1, 2021. Section 1.250(b)–2(h) applies to taxable years ending on or after March 4, 2019. However, taxpayers may choose to apply §§ 1.250(a)–1 and 1.250(b)–1 through 1.250(b)–6 for taxable years beginning on or after January 1, 2018, and before January 1, 2021, provided they apply the regulations in their entirety (other than § 1.250(b)–3(f) and the applicable provisions in § 1.250(b)–4(d)(3) or § 1.250(b)–5(e)(4))
§ 1.250(a)–1 Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).
(a) Scope. This section provides rules for determining the amount of a domestic corporation’s deduction for
foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). Paragraph (b) of this section provides general rules for determining the amount of the deduction. Paragraph (c) of this section provides definitions relevant for determining the amount of the deduction. Paragraph (d) of this section provides reporting requirements for a domestic corporation claiming the deduction. Paragraph (e) of this section provides a rule for determining the amount of the deduction of a member of a consolidated group. Paragraph (f) of this section provides examples illustrating the application of this section.

(b) Allowance of deduction—(1) In general. A domestic corporation is allowed a deduction for any taxable year equal to the sum of—

(i) 37.5 percent of its foreign-derived intangible income for the year; and
(ii) 50 percent of—
(A) Its global intangible low-taxed income for the year; and
(B) The amount treated as a dividend received by the corporation under section 78 which is attributable to its GILTI for the year.

(2) Taxable income limitation. In the case of a domestic corporation with a section 250(a)(2) amount for a taxable year, for purposes of applying paragraph (b)(1) of this section for the year—

(i) The corporation’s FDII for the year (if any) is reduced (but not below zero) by an amount that bears the same ratio to the corporation’s section 250(a)(2) amount that the corporation’s FDII for the year bears to the sum of the corporation’s FDII and GILTI for the year; and

(ii) The corporation’s GILTI for the year (if any) is reduced (but not below zero) by the excess of the corporation’s section 250(a)(2) amount over the amount of the reduction described in paragraph (b)(2)(i) of this section.

(3) Reduction in deduction for taxable years after 2025. For any taxable year of a domestic corporation beginning after December 31, 2025, paragraph (b)(1) of this section applies by substituting—

(i) 21.875 percent for 37.5 percent in paragraph (b)(1)(i) of this section; and
(ii) 37.5 percent for 50 percent in paragraph (b)(1)(ii) of this section.

(4) Treatment under section 4940. For purposes of section 4940(c)(3)(A), a deduction under section 250(a) is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income.

(c) Definitions. The following definitions apply for purposes of this section.

(1) Domestic corporation. The term domestic corporation has the meaning set forth in section 7701(a), but does not include a regulated investment company (as defined in section 851), a real estate investment trust (as defined in section 856), or an S corporation (as defined in section 1361).

(2) Foreign-derived intangible income (FDII). The term foreign-derived intangible income or FDII has the meaning set forth in §1.1250(b)–1(b).

(3) Global intangible low-taxed income (GILTI). The term global intangible low-taxed income or GILTI means, with respect to a domestic corporation for a taxable year, the corporation’s GILTI inclusion amount under §1.951A–1(c) for the taxable year.

(4) Section 250(a)(2) amount. The term section 250(a)(2) amount means, with respect to a domestic corporation for a taxable year, the excess (if any) of the sum of the corporation’s FDII and GILTI (determined without regard to section 250(a)(2) and paragraph (b)(2) of this section), over the corporation’s taxable income. For a corporation that is subject to the unrelated business income tax under section 511, taxable income is determined only by reference to that corporation’s unrelated business taxable income defined under section 512.

(5) Taxable income—(i) In general. The term taxable income has the meaning set forth in section 63(a) determined without regard to the deduction allowed under section 250 and this section.

(ii) [Reserved]

(d) Reporting requirement. Each domestic corporation (or individual making an election under section 962) that claims a deduction under section 250 for a taxable year must make an annual return on Form 8993, “Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)” (or any successor form) for such year, setting forth the information, in such form and manner, as Form 8993 (or any successor form) or its instructions prescribe. Returns on Form 8993 (or any successor form) for a taxable year must be filed with the domestic corporation’s (or in the case of a domestic corporation’s member of a consolidated group) income tax return on or before the due date (taking into account extensions) for filing the corporation’s (or in the case of a domestic corporation’s member of a consolidated group) income tax return.

(e) Determination of deduction for consolidated groups. A member of a consolidated group (as defined in §1.1502–1(b)) determines its deduction under section 250(a) in the following manner:

(1) [Reserved]

(2) [Reserved]

(3) Reduction in deduction for taxable years after 2025. For any taxable year of a domestic corporation beginning after December 31, 2025, paragraph (b)(1) of this section applies by substituting—

(i) 21.875 percent for 37.5 percent in paragraph (b)(1)(i) of this section; and
(ii) 37.5 percent for 50 percent in paragraph (b)(1)(ii) of this section.

§1.250(b)–1 Computation of foreign-derived intangible income (FDII).

(a) Scope. This section provides rules for computing FDII. Paragraph (b) of this section defines FDII. Paragraph (c) of this section provides definitions that are relevant for computing FDII. Paragraph (d) of this section provides rules for purposes of computing deduction eligible income (DEI) and foreign-derived deduction eligible income (FDDEI). Paragraph (e) of this section provides rules for computing the DEI and FDDEI of a domestic corporate partner. Paragraph (f) of this section provides a rule for computing the FDII of a member of a consolidated group. Paragraph (g) of this section provides a rule for computing the FDII of a tax-exempt corporation.

(b) Definition of FDII. Subject to the provisions of this section, the term FDII means, with respect to a domestic corporation for a taxable year, the corporation’s deemed intangible income for the year multiplied by the
corporation’s foreign-derived ratio for the year.

(c) Definitions. This paragraph (c) provides definitions that apply for purposes of this section and §§1.250(b)–2 through 1.250(b)–6.

(1) Controlled foreign corporation. The term controlled foreign corporation has the meaning set forth in section 957(a) and §1.957–1(a).

(2) Deduction eligible income. The term deduction eligible income or DEI means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation’s gross DEI for the year over the deductions properly allocable to gross DEI for the year, as determined under paragraph (d)(2) of this section.

(3) Deemed intangible income. The term deemed intangible income means, with respect to a domestic corporation and a taxable year, 10 percent of the corporation’s qualified business asset investment for the year.

(4) Dividend. The term dividend has the meaning set forth in section 316, and includes any amount treated as a dividend under any other provision of subtitle A of the Internal Revenue Code or the regulations in this part (for example, under section 78, 336(a)(2), 367(b), or 1248).

(5) Domestic corporation. The term domestic corporation has the meaning set forth in §1.250(a)–1(c)(1).

(6) Domestic oil and gas extraction income. The term domestic oil and gas extraction income means income described in section 907(c)(1), substituting “within the United States” for “within the United States.”

(7) FDDEI sale. The term FDDEI sale has the meaning set forth in §1.250(b)–4(b).

(8) FDDEI service. The term FDDEI service has the meaning set forth in §1.250(b)–5(b).

(9) FDDEI transaction. The term FDDEI transaction means a FDDEI sale or a FDDEI service.

(10) Foreign branch income. The term foreign branch income has the meaning set forth in section 904(d)(2)(J) and §1.904–4(f)(2).

(11) Foreign-derived deduction eligible income. The term foreign-derived deduction eligible income or FDDEI means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation’s gross FDDEI for the year, over the deductions properly allocable to gross FDDEI for the year, as determined under paragraph (d)(2) of this section.

(12) Foreign-derived deduction eligible income or FDDEI means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation’s gross FDDEI for the year, as determined under paragraph (d)(2) of this section.

(13) Foreign-derived ratio. The term foreign-derived ratio means, with respect to a domestic corporation for a taxable year, the ratio (not to exceed one) of the corporation’s FDDEI for the year to the corporation’s DEI for the year. If a domestic corporation has no FDDEI for a taxable year, the corporation’s foreign-derived ratio is zero for the taxable year.

(14) Gross RDEI. The term gross RDEI means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the corporation or partnership’s gross DEI for the year that is not included in gross FDDEI.

(15) Gross DEI. The term gross DEI means, with respect to a domestic corporation or a partnership for a taxable year, the excess income of the corporation or partnership for the year determined without regard to the following items of gross income—

(i) Amounts included in gross income under section 951(a)(1);

(ii) GILTI (as defined in §1.250(a)–1(c)(3));

(iii) Financial services income (as defined in section 904(d)(2)(D) and §1.904–4(e)(1)(ii));

(iv) Dividends received from a controlled foreign corporation with respect to which the corporation or partnership is a United States shareholder;

(v) Domestic oil and gas extraction income; and

(vi) Foreign branch income.

(16) Gross FDDEI. The term gross FDDEI means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the gross DEI of the corporation or partnership for the year which is derived from all of its FDDEI transactions.

(17) Modified affiliated group.—(i) In general. The term modified affiliated group means an affiliated group as defined in section 1504(a) determined by substituting “more than 50 percent” for “at least 80 percent” each place it appears, and without regard to section 1504(b)(2) and (3).

(ii) Special rule for noncorporate entities. Any person (other than a corporation) that is controlled by one or more members of a modified affiliated group (including one or more persons treated as a member or members of a modified affiliated group by reason of this paragraph (c)(17)(ii)) or that controls any such member is treated as a member of the modified affiliated group.

(iii) Definition of control. For purposes of paragraph (c)(17)(ii) of this section, the term control has the meaning set forth in section 954(d)(3).

(18) Qualified business asset investment. The term qualified business asset investment or QBAI has the meaning set forth in §1.250(b)–2(b).

(19) Related party. The term related party means, with respect to any person, any member of a modified affiliated group that includes such person.

(20) United States shareholder. The term United States shareholder has the meaning set forth in section 951(b) and §1.951–1(g).

(d) Treatment of cost of goods sold and allocation and apportionment of deductions.—(1) Cost of goods sold for determining gross DEI and gross FDDEI. For purposes of determining the gross income included in gross DEI and gross FDDEI of a domestic corporation or a partnership, the cost of goods sold of the corporation or partnership is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method that is applied consistently. Cost of goods sold must be attributed to gross receipts with respect to gross DEI or gross FDDEI regardless of whether certain costs included in cost of goods sold can be associated with activities undertaken in an earlier taxable year (including a year before the effective date of section 250). A domestic corporation or partnership may not segregate cost of goods sold with respect to a particular product into component costs and attribute those component costs disproportionately to gross receipts with respect to amounts excluded from gross DEI or gross FDDEI, as applicable.

(2) Deductions properly allocable to gross DEI and gross FDDEI.—(i) In general. For purposes of determining a domestic corporation’s deductions that are properly allocable to gross DEI and gross FDDEI, the corporation’s deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of §§1.861–8 through 1.861–14T and 1.861–17 by treating section 250(b) as an operative section described in §1.861–8(f). In allocating and apportioning deductions under §§1.861–8 through 1.861–14T and 1.861–17, gross FDDEI and gross RDEI are treated as separate statutory groupings. The deductions allocated and apportioned to gross DEI equal the sum of the deductions allocated and apportioned to gross FDDEI and gross RDEI. All items of gross income determined in paragraphs (c)(15)(i) through (vi) of this section are in the residual grouping.
(ii) **Determination of deductions to allocate.** For purposes of determining the deductions of a domestic corporation for a taxable year properly allocable to gross DEI and gross FDDEI, the deductions of the corporation for the taxable year are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250.

(3) **Examples.** The following examples illustrate the application of this paragraph (d).

(i) **Assumed facts.** The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation that is not a member of a consolidated group.

(B) All sales and services are provided to persons that are not related parties.

(C) All sales and services to foreign persons qualify as FDDEI transactions.

(ii) **Examples—**

(A) **Example 1: Allocation of deductions—**

(1) **Facts.** For a taxable year, DC manufactures products A and B in the United States. DC sells products A and B and provides services associated with products A and B to United States and foreign persons.

DC's QBAI for the taxable year is $1,000x. DC has $300x of deductible interest expense allowed under section 163. DC has assets with a tax book value of $2,500x. The tax book value of DC's assets used to produce products A and B and services is split evenly between assets that produce gross FDDEI and assets that produce gross RDEI. DC has $840x of supportive deductions, as defined in §1.861–8(b)(3), attributable to general and administrative expenses incurred for the purpose of generating the class of gross income that consists of gross DEI. DC apportions the $840x of deductions on the basis of gross income in accordance with §1.861–8T(c)(1).

For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, DC attributes $200x of cost of goods sold to Product A and $400x of cost of goods sold to Product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of such product sold to foreign persons and the gross receipts of such product sold to United States persons. The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

<table>
<thead>
<tr>
<th>TABLE 1 TO PARAGRAPH (d)(3)(ii)(A)(1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>----------------</td>
</tr>
<tr>
<td>Gross receipts from U.S. persons</td>
</tr>
<tr>
<td>Gross receipts from foreign persons</td>
</tr>
<tr>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>Gross income</td>
</tr>
<tr>
<td>Tax book value of assets used to produce products/services</td>
</tr>
</tbody>
</table>

(ii) **Determination of foreign-derived deduction eligible income.** To calculate its FDDEI, DC must determine the amount of its deductions that are allocated and apportioned to gross FDDEI and then subtract those amounts from gross FDDEI. DC’s interest deduction of $300x is allocated and apportioned to gross FDDEI on the basis of gross income. Accordingly, supportive deductions of $420x are apportioned to DC’s gross FDDEI. DC’s FDDEI is $230x, which is equal to its gross FDDEI of $800x less $150x of interest expense deduction and $420x of supportive deductions.

(iii) **Determination of deemed intangible income.** DC’s deemed tangible income return is $100x, which is equal to 10 percent of its QBAI of $1,000x. DC’s DEI is $460x, which is equal to its gross DEI of $1,600x less $300x of interest expense deductions and $840x of supportive deductions. Therefore, DC’s deemed intangible income is $360x, which is equal to the excess of its DEI of $460x over its deemed tangible income return of $100x.

(iv) **Determination of foreign-derived intangible income.** DC’s foreign-derived ratio is 50 percent, which is the ratio of DC’s FDDEI of $230x to its DEI of $460x. Therefore, DC’s FDI is $180x, which is equal to DC’s deemed intangible income of $360x multiplied by its foreign-derived ratio of 50 percent.

(B) **Example 2: Allocation of deductions with respect to a partnership—**

(1) **Facts—**

DC’s operations. DC is engaged in the production and sale of products consisting of two separate product groups in three-digit Standard Industrial Classification (SIC) Industry Groups, hereafter referred to as Group AAA and Group BBB. All of the gross income of DC is included in gross DEI. DC incurs $250x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, DC attributes $210x of cost of goods sold to Group AAA products and $900x of cost of goods sold to Group BBB products, and then attributes the cost of goods sold with respect to each such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which DC attributes the cost of goods sold is a reasonable method. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

<table>
<thead>
<tr>
<th>TABLE 2 TO (d)(3)(ii)(B)(1)(i)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group AAA products</td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>Gross receipts from U.S. persons</td>
</tr>
<tr>
<td>Gross receipts from foreign persons</td>
</tr>
<tr>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>Cost of goods sold for gross receipts from U.S. persons</td>
</tr>
<tr>
<td>Cost of goods sold for gross receipts from foreign persons</td>
</tr>
<tr>
<td>Total cost of goods sold</td>
</tr>
</tbody>
</table>
(ii) **PRS’s operations.** In addition to its own operations, DC is a partner in PRS, a partnership that also produces products described in SIC Group AAA. DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. During the taxable year, PRS sells Group AAA products solely to foreign persons, and all of its gross income is included in gross DEI. PRS has $400 of gross receipts from sales of Group AAA products for the taxable year and incurs $100x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, PRS attributes $200x of cost of goods sold to products, and then attributes the cost of goods sold with respect to such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which PRS attributes the cost of goods sold is a reasonable method. DC’s distributive share of PRS taxable items is $100x of gross income and $50x of R&E deductions, and DC’s share of PRS’s gross receipts from sales of Group AAA products for the taxable year is $200x under § 1.861–17(f)(3).

(iii) **Application of the sales method to allocate and apportion R&E.** DC applies the sales method to apportion its R&E deductions under § 1.861–17. Neither DC nor PRS licenses or sells its intangible property to controlled or uncontrolled corporations in a manner that necessitates including the sales to such corporations for purposes of apportioning DC’s R&E deductions.

(2) **Analysis—Determinations of gross DEI and gross FDDEI.** Under paragraph (d)(1) of this section, DC’s gross DEI, gross FDDEI, and deductions allocable to those amounts include its distributive share of gross DEI, gross FDDEI, and deductions of PRS. Thus, DC’s gross DEI for the year is $400x ($300x attributable to DC and $100x attributable to DC’s interest in PRS). DC’s gross income from sales of Group AAA products to foreign persons is $300x ($100x of gross receipts minus attributable cost of goods sold of $200x). DC’s gross expense from sales of Group BBB products to foreign persons is $100x ($400x of gross receipts minus attributable cost of goods sold of $300x). DC’s gross FDDEI for the year is $230x ($30x from DC’s sale of Group AAA products plus $100x from DC’s sale of Group BBB products plus DC’s distributive share of PRS’s gross FDDEI of $100x).

(ii) Allocation and apportionment of R&E deductions. To determine FDDEI, DC must allocate and apportion its R&E expense of $300x ($250x incurred directly by DC and $50x incurred indirectly through DC’s interest in PRS). In accordance with § 1.861–17, R&E expenses are first allocated to a class of gross income related to a three-digit SIC group code. DC’s R&E expenses related to products in Group AAA are $90x ($40x incurred directly by DC and $50x incurred indirectly through DC’s interest in PRS) and its expenses related to Group BBB are $210x. See paragraph (d)(2)(i) of this section. Accordingly, all R&E expense attributable to a particular SIC group code is apportioned on the basis of the amounts of sales within that SIC group code. Total sales within Group AAA were $300x ($200x directly by DC and $200x attributable to DC’s interest in PRS), $300x of which were made to foreign persons ($100x directly by DC and $200x attributable to DC’s interest in PRS). Therefore, the $90x of R&E expense related to Group AAA is apportioned $54x to gross FDDEI ($90x × $300x/$500x) and $36x to gross DEI ($90x × $200x/$500x). Total sales within Group BBB were $240x, $400x of which were made to foreign persons. Therefore, the $210x of R&E expense related to products in Group BBB is apportioned $70x to gross FDDEI ($210x × $400x/$1,200x) and $140x to gross R&E ($210x × $800x/$1,200x).

(e) **Domestic corporate partners—(1) In general.** A domestic corporation’s DEI and FDDEI for a taxable year are determined by taking into account the corporation’s share of gross DEI, gross FDDEI, and deductions of any partnership (whether domestic or foreign) in which the corporation is a direct or indirect partner. For purposes of the preceding sentence, a domestic corporation’s share of each such item of a partnership is determined in accordance with the corporation’s distributive share of the underlying items of income, gain, deduction, and loss of the partnership that comprise such amounts. See § 1.250(b)–2(g) for rules on calculating the increase to a domestic corporation’s QBAI by the corporation’s share of partnership QBAI.

(2) **Reporting requirement for partnership with domestic corporate partners.** A partnership that has one or more direct partners that are domestic corporations and that is required to file a return under section 6031 must furnish to each such partner on or with such partner’s Schedule K–1 (Form 1065 or any successor form) by the due date (including extensions) for furnishing Schedule K–1 the partner’s share of the partnership’s gross DEI, gross FDDEI, deductions that are properly allocable to the partnership’s gross DEI and gross FDDEI, and partnership QBAI (as determined under § 1.250(b)–2(g)) for each taxable year in which the partnership has gross DEI, gross FDDEI, deductions that are properly allocable to the partnership’s gross DEI or gross FDDEI, or partnership specified tangible property (as defined in § 1.250(b)–2(g)(5)). In the case of tiered partnerships where one or more partners of an upper-tier partnership are domestic corporations, a lower-tier partnership must report the amount specified in this paragraph (e)(2) to the upper-tier partnership to allow reporting of such information to any partner that is a domestic corporation. To the extent that a partnership cannot determine the information described in the first sentence of this paragraph (e)(2), the partnership must instead furnish to each partner its share of the partnership’s attributes that a partner needs to determine the partner’s gross DEI, gross FDDEI, deductions that are properly allocable to the partner’s gross DEI and gross FDDEI, and the partner’s adjusted bases in partnership specified tangible property.

(3) **Examples.** The following examples illustrate the application of this paragraph (e).

(i) **Assumed facts.** The following facts are assumed for purposes of the examples—

(A) DC, a domestic corporation, is a partner in PRS, a partnership.

(B) FP and FP2 are foreign persons.

(C) FC is a foreign corporation.

(D) The allocations under PRS’s partnership agreement satisfy the requirements of section 704.

(E) No partner of PRS is a related party of DC.

(F) DC, PRS, and FC all use the calendar year as their taxable year.

(G) PRS has no items of income, loss, or deduction for its taxable year, except the items of income described.

(ii) **Examples—**

(A) **Example 1: Sale by partnership to foreign person—(1) Facts.** Under the terms of the partnership agreement, DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. For the taxable year, PRS recognizes $20x of gross income on the sale of general property (as defined in § 1.250(b)–...
Example 1: Partnership with a loss in gross FDDEI—(1) Facts. The facts are the same as in paragraph (e)(3)(i)(A)(1) of this section (the facts in Example 1), except that in the same taxable year, PRS also sells property to FP2, a foreign person (as determined under §1.250(b)–4(c)), for a foreign use (as determined under §1.250(b)–4(d)). After taking into account both sales, PRS has a gross loss of $30x.

(2) Analysis. Both the sale of property to FP and the sale of property to FP2 are FDDEI sales because each sale is described in §1.250(b)–4(b). DC’s share of PRS’s gross loss ($15x) from the sales included in DC’s gross DEI and gross FDDEI for the taxable year.

(D) Example 4: Sale by partnership to foreign related party of the partnership—(1) Facts. Under the terms of the partnership agreement, DC has 25 percent of the capital and profits interest in the partnership and is allocated 25 percent of all income, gain, loss, and deductions of PRS. PRS owns 100 percent of the single class of stock of FC. In the taxable year, PRS has $20x of gain on the sale of FC’s general property (as defined in §1.250(b)–4(c)), because FC did not sell the property, or use the property in connection with other property sold or the provision of a service, to a foreign unrelated party before the property was subject to a domestic use, the sale by PRS to FC is not a FDDEI sale. See §1.250(b)–4(c). Accordingly, the gain from the sale ($20x) is included in PRS’s gross DEI but not its gross FDDEI. DC’s share of PRS’s gain ($5x) is included in DC’s gross DEI but not gross FDDEI. This is the result notwithstanding that FC is not a related party of DC because FC and DC are not members of a modified affiliated group within the meaning of paragraph (c)(17) of this section.

(f) Determination of FDII for consolidated groups. A member of a consolidated group (as defined in §1.1502–1(h)) determines its FDII under the rules provided in §1.1502–50.

(g) Determination of FDII for tax-exempt corporations. The FDII of a corporation that is subject to the unrelated business income tax under section 511 is determined only by reference to that corporation’s items of income, gain, deduction, or loss, and adjustments (as defined in section 1562), that are taken into account in computing the corporation’s unrelated business taxable income (as defined in section 512). For example, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property used in the production of both unrelated business income and gross income that is not unrelated business income, only the portion of the basis of such property taken into account in computing the corporation’s unrelated business taxable income is taken into account in determining the corporation’s QBAI.

Similarly, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property that is used in both the production of gross DEI and the production of gross income that is not gross DEI, only the corporation’s unrelated business income is taken into account in determining the corporation’s dual use ratio with respect to such property under §1.250(b)–2(d)(3).

§1.250(b)–2 Qualified business asset investment (QBAI).

(a) Scope. This section provides general rules for determining the qualified business asset investment of a domestic corporation for purposes of determining its deemed tangible income return under §1.250(b)–1(c)(4). Paragraph (b) of this section defines qualified business asset investment (QBAI). Paragraph (c) of this section defines tangible property and specified tangible property. Paragraph (d) of this section determines the portion of property that is specified tangible property when the property is used in the production of both gross DEI and gross income that is not gross DEI. Paragraph (e) of this section provides rules for determining the adjusted basis of specified tangible property. Paragraph (f) of this section provides rules for determining QBAI of a domestic corporation with a short taxable year. Paragraph (g) of this section provides rules for increasing the QBAI of a domestic corporation by reason of property owned through a partnership. Paragraph (h) of this section provides an anti-avoidance rule that disregards certain transfers when determining the QBAI of a domestic corporation.

(b) Definition of qualified business asset investment. The term qualified business asset investment (QBAI) means the average of a domestic corporation’s aggregate adjusted bases as of the close of each quarter of the domestic corporation’s taxable year in specified tangible property that is used in a trade or business of the domestic corporation and is of a type with respect to which a deduction is allowable under section 167. In the case of partially depreciable property, only the depreciable portion of the property is of a type with respect to which a deduction is allowable under section 167.

(c) Specified tangible property—(1) In general. The term specified tangible property means, with respect to a domestic corporation for a taxable year, tangible property of the domestic corporation used in the production of gross DEI for the taxable year. For purposes of the preceding sentence, tangible property of a domestic corporation is used in the production of gross DEI for a taxable year if some or all of the depreciation or cost recovery allowance with respect to the tangible property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under §1.250(b)–1(d)(2) or capitalized to inventory or other property held for sale, some or all of the gross income or loss from the sale of which is taken into account in determining DEI of the domestic corporation for the taxable year.

(2) Tangible property. The term tangible property means property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 without regard to section 168(f)(1), (2), or (5), section 168(k)(2)(A)(ii)(IV), or (V), and the date placed in service.

(d) Dual use property—(1) In general. The amount of the adjusted basis in dual use property of a domestic corporation is treated as adjusted basis in specified tangible property for the taxable year is
the average of the domestic corporation’s adjusted basis in the property multiplied by the dual use ratio with respect to the property for the taxable year.

(2) Definition of dual use property. The term dual use property means, with respect to a domestic corporation and a taxable year, specified tangible property of the domestic corporation that is used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year. For purposes of the preceding sentence, specified tangible property of a domestic corporation is used in the production of gross DEI and the production of gross income that is not gross DEI for a taxable year if less than all of the depreciation or cost recovery allowance with respect to the property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under § 1.250(b)–1(d)(2) or capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year.

(3) Dual use ratio. The term dual use ratio means, with respect to dual use property, a domestic corporation, and a taxable year, a ratio (expressed as a percentage) calculated as—

(i) The sum of—

(A) The depreciation deduction or cost recovery allowance with respect to the property that is allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under § 1.250(b)–1(d)(2); and

(B) The depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year; divided by

(ii) The sum of—

(A) The total amount of the domestic corporation’s depreciation deduction or cost recovery allowance with respect to the property for the taxable year; and

(B) The total amount of the domestic corporation’s depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the income or loss of the domestic corporation for the taxable year.

(4) Example. The following example illustrates the application of this paragraph (d).

(i) Facts. DC, a domestic corporation, owns a machine that produces both gross DEI and income that is not gross DEI. The average adjusted basis of the machine for the taxable year in the hands of DC is $4,000x. The depreciation with respect to the machine for the taxable year is $400x, $320x of which is capitalized to inventory of Product A, gross income or loss from the sale of which is taken into account in determining DC’s gross DEI for the taxable year, and $80x of which is capitalized to inventory of Product B, gross income or loss from the sale of which is not taken into account in determining DC’s gross DEI for the taxable year. DC also owns an office building for its administrative functions with an average adjusted basis for the taxable year of $10,000x. DC does not capitalize depreciation with respect to the office building to inventory or other property held for sale. DC’s depreciation deduction with respect to the office building is $1,000x for the taxable year, $750x of which is allocated and apportioned to gross DEI under § 1.250(b)–1(d)(2), and $250x of which is allocated and apportioned to income other than gross DEI under § 1.250(b)–1(d)(2).

(ii) Analysis—(A) Dual use property. The machine and office building are property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 (without regard to section 168(f)(1), (2), or (5), section 168(h)(2)(A)(II), (IV), or (V), and the date placed in service). Therefore, under paragraph (c)(2) of this section, the machine and office building are dual use tangible property. Furthermore, because the machine and office building are used in the production of gross DEI for the taxable year within the meaning of paragraph (c)(1) of this section, the machine and office building are specified tangible property. Finally, because the machine and office building are used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year within the meaning of paragraph (d)(2) of this section, the machine and office building are dual use property. Therefore, under paragraph (d)(1) of this section, the amount of DC’s adjusted basis in the machine and office building that is treated as depreciation is its basis in specified tangible property for the taxable year is determined by multiplying DC’s adjusted basis in the machine and office building by DC’s dual use ratio with respect to the machine and office building determined under paragraph (d)(5) of this section.

(B) Depreciation not capitalized to inventory. Because none of the depreciation with respect to the office building is capitalized to inventory or other property held for sale, DC’s dual use ratio with respect to the office building is determined entirely by reference to the depreciation deduction with respect to the office building. Therefore, under paragraph (d)(3) of this section, DC’s dual use ratio with respect to the office building for Year 1 is 75 percent, which is DC’s depreciation deduction with respect to the office building that is allocated and apportioned to gross DEI under § 1.250(b)–1(d)(2) for Year 1 ($750x), divided by the total amount of DC’s depreciation deduction with respect to the office building for Year 1 ($1000x). Accordingly, under paragraph (d)(1) of this section, $7,500x ($10,000x x 0.75) of DC’s average adjusted bases in the office building is taken into account under paragraph (b) of this section in determining DC’s QBAI for the taxable year.

(C) Depreciation capitalized to inventory. Because all of the depreciation with respect to the machine is capitalized to inventory, DC’s dual use ratio with respect to the machine is determined entirely by reference to the depreciation with respect to the machine that is capitalized to inventory and included in cost of goods sold. Therefore, under paragraph (d)(3) of this section, DC’s dual use ratio with respect to the machine for the taxable year is 80 percent, which is DC’s depreciation with respect to the machine that is capitalized to inventory of Product A, the gross income or loss from the sale of which is taken into account in determining DC’s DEI for the taxable year ($320x), divided by DC’s depreciation with respect to the machine that is capitalized to inventory, the gross income or loss from the sale of which is taken into account in determining DC’s DEI for the taxable year ($400x). Accordingly, under paragraph (d)(1) of this section, $3,200x ($4,000x x 0.8) of DC’s average adjusted basis in the machine is taken into account under paragraph (b) of this section in determining DC’s QBAI for the taxable year.

(e) Determination of adjusted basis of specified tangible property—(1) In general. The adjusted basis in specified tangible property for purposes of this section is determined by using the cost capitalization methods of accounting used by the domestic corporation for purposes of determining the gross income and deductions of the domestic corporation and the alternative depreciation system under section 168(g), and by allocating the depreciation deduction with respect to such property for the domestic corporation’s taxable year ratably to each day during the period in the taxable year to which such depreciation relates. For purposes of the preceding sentence, the period in the taxable year to which such depreciation relates is determined without regard to the applicable convention under section 168(d).

(2) Effect of change in law. The adjusted basis in specified tangible property is determined without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A.

(3) Specified tangible property placed in service before enactment of section 250. The adjusted basis in specified tangible property placed in service before December 22, 2017, is determined using the alternative depreciation system under section 168(g), as if this system had applied from the date that the property was placed in service.
(f) Special rules for short taxable years—(1) In general. In the case of a domestic corporation that has a taxable year that is less than twelve months (a short taxable year), the rules for determining the QBAI of the domestic corporation under this section are modified as provided in paragraphs (f)(2) and (3) of this section with respect to the taxable year.

(2) Determination of when the quarter closes. For purposes of determining when the quarter closes, in determining the QBAI of a domestic corporation for a short taxable year, the quarters of the domestic corporation for purposes of this section are the full quarters beginning and ending within the short taxable year (if any), determining quarter length as if the domestic corporation did not have a short taxable year, plus one or more short quarters (if any).

(3) Reduction of qualified business asset investment. The QBAI of a domestic corporation for a short taxable year is the sum of—

(i) The sum of the domestic corporation’s aggregate adjusted bases in specified tangible property as of the close of each full quarter (if any) in the domestic corporation’s taxable year divided by four; plus

(ii) The domestic corporation’s aggregate adjusted bases in specified tangible property as of the close of each short quarter (if any) in the domestic corporation’s taxable year multiplied by the sum of the number of days in each short quarter divided by 365.

(4) Example. The following example illustrates the application of this paragraph (f).

(i) Facts. A, an individual, owns all of the stock of DC, a domestic corporation. A owns DC from the beginning of the taxable year. On July 15 of the taxable year, A sells DC to USP, a domestic corporation that is unrelated to A. DC becomes a member of the controlled group of which USP is the common parent and as a result, under §1.1502-76(b)(2)(ii), DC’s taxable year is treated as ending on July 15. USP and DC both use the calendar year as their taxable year. DC’s aggregate adjusted bases in specified tangible property for the taxable year are $250x as of March 31, $300x as of June 30, $275x as of July 15, $500x as of September 30, and $450x as of December 31.

(ii) Analysis—(A) Determination of short taxable years and quarters. DC has two short taxable years during the year. The first short taxable year is from January 1 to July 15, with two full quarters (January 1 through March 31 and April 1 through June 30) and one short quarter (July 1 through July 15). The second taxable year is from July 16 to December 31, with one short quarter (July 16 through September 30) and one full quarter (October 1 through December 31).

(B) Calculation of qualified business asset investment for the first short taxable year.

Under paragraph (f)(2) of this section, for the first short taxable year, DC has three quarter closes (March 31, June 30, and July 15). Under paragraph (f)(3) of this section, the QBAI of DC for the first short taxable year is $148.80x, the sum of $137.50x (($250x + $300x)/4) attributable to the two full quarters and $11.30x ($275x × 15/365) attributable to the short quarter.

(C) Calculation of qualified business asset investment for the second short taxable year. Under paragraph (f)(2) of this section, for the second short taxable year, DC has two quarter closes (September 30 and December 31). Under paragraph (f)(3) of this section, the QBAI of DC for the second short taxable year is $217.98x, the sum of $112.50x ($450x/4) attributable to the one full quarter and $105.48x ($500x × 77/365) attributable to the short quarter.

(g) Partnership property—(1) In general. If a domestic corporation holds an interest in one or more partnerships during a taxable year (including indirectly through one or more partnerships that are partners in a lower-tier partnership), the QBAI of the domestic corporation for the taxable year (determined without regard to this paragraph (g)(1)) is increased by the sum of the domestic corporation’s partnership QBAI with respect to each partnership for the taxable year.

(2) Determination of partnership QBAI. For purposes of paragraph (g)(1) of this section, the term partnership QBAI means, with respect to a partnership, a domestic corporation, and a taxable year, the sum of the domestic corporation’s partner adjusted basis in each partnership specified tangible property of the partnership for each partnership taxable year that ends with or within the taxable year. If a partnership taxable year is less than twelve months, the principles of paragraphs (f)(1) of this section apply in determining a domestic corporation’s partnership QBAI with respect to the partnership.

(3) Determination of partner adjusted basis—(i) In general. For purposes of paragraph (g)(2) of this section, the term partner adjusted basis means the amount described in paragraph (g)(3)(ii) of this section with respect to sole use partnership property or paragraph (g)(3)(iii) of this section with respect to dual use partnership property. The principles of section 706(d) apply to this determination.

(ii) Sole use partnership property—(A) In general. The amount described in this paragraph (g)(3)(ii), with respect to sole use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation’s proportional share of the partnership’s depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year.

(B) Definition of sole use partnership property. The term sole use partnership property means, with respect to a partnership, a partnership taxable year, and a domestic corporation, partnership property specified tangible property of the partnership that is used in the production of only gross DEI of the domestic corporation for the taxable year in which or with which the partnership taxable year ends. For purposes of the preceding sentence, partnership property specified tangible property of a partnership is used in the production of only gross DEI for a taxable year if all the domestic corporation’s dittributive share of the partnership’s depreciation deduction or cost recovery allowance with respect to the property (if any) for the partnership taxable year that ends with or within the taxable year is allocated and apportioned to the domestic corporation’s gross DEI for the taxable year under §1.250(b)–1(d)(2) and, if any of the partnership’s depreciation or cost recovery allowance with respect to the property is capitalized to inventory or other property held for sale, all the domestic corporation’s distributive share of the partnership’s gross income or loss from the sale of such inventory or other property for the partnership taxable year that ends with or within the taxable year is taken into account in determining the DEI of the domestic corporation for the taxable year.

(iii) Dual use partnership property—(A) In general. The amount described in this paragraph (g)(3)(iii), with respect to dual use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation’s proportional share of the partnership’s depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year.

(B) Definition of dual use partnership property. The term dual use partnership property means partnership property specified tangible property other than sole use partnership property.
(4) **Determination of proportionate share of the partnership's adjusted basis in partnership specified tangible property**—(i) In general. For purposes of paragraph (g)(3) of this section, the domestic corporation's proportionate share of the partnership adjusted basis in partnership specified tangible property for a partnership taxable year is the partnership adjusted basis in the property multiplied by the domestic corporation's proportionate share ratio with respect to the property for the partnership taxable year. Solely for purposes of determining the proportionate share ratio under paragraph (g)(4)(ii) of this section, the partnership's calculation of, and a partner's distributive share of, any income, loss, depreciation, or cost recovery allowance is determined under section 704(b).

(ii) **Proportionate share ratio.** The term *proportionate share ratio* means, with respect to a partnership, a partnership taxable year, and a domestic corporation, the ratio (expressed as a percentage) calculated as—

[A] The sum of—

(1) The domestic corporation's distributable share of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(2) The amount of the partnership's depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the domestic corporation's distributive share of the partnership's income or loss for the partnership taxable year; divided by

[B] The sum of—

(1) The total amount of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(2) The total amount of the partnership's depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the partnership's income or loss for the partnership taxable year.

(iii) Used in the production of gross income included in the domestic corporation's gross DEI.

(6) **Determination of partnership adjusted basis.** For purposes of this paragraph (g), the term *partnership adjusted basis* means, with respect to a partnership, partnership specified tangible property, and a partnership taxable year, the amount equal to the average of the partnership's adjusted basis in the partnership specified tangible property as of the close of each quarter in the partnership taxable year determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)[B] or section 734(b)(2)[B] that are attributable to distributions of tangible property (as defined in paragraph (c)(2) of this section) and for adjustments under section 734(b)(1)(A) or 734(b)(2)(A). The principles of paragraphs (e) and (h) of this section apply for purposes of determining a partnership's adjusted basis in partnership specified tangible property and the proportionate share of the partnership's adjusted basis in partnership specified tangible property.

(7) **Determination of partner-specific QBAI basis.** For purposes of this paragraph (g), the term *partner-specific QBAI basis* means, with respect to a domestic corporation, a partnership, and partnership specified tangible property, the amount that is equal to the average of the basis adjustment under section 743(b) that is allocated to the partnership specified tangible property of the partnership with respect to the domestic corporation as of the close of each quarter in the partnership taxable year. For this purpose, a negative basis adjustment under section 743(b) is expressed as a negative number. The principles of paragraphs (e) and (h) of this section apply for purposes of determining the partner-specific QBAI basis with respect to partnership specified tangible property.

(8) **Examples.** The following examples illustrate the rules of this paragraph (g).

(i) **Assumed facts.** Except as otherwise stated, the following facts are assumed for purposes of the examples:

(A) DC, DC1, DC2, and DC3 are domestic corporations.

(B) PRS is a partnership and its allocations satisfy the requirements of section 704.

(C) All properties are partnership specified tangible property.

(D) All persons use the calendar year as their taxable year.

(E) There is no partner-specific QBAI basis with respect to any property.

(ii) **Example 1: Sole use partnership property.**—(A) Facts. DC is a partner in PRS. PRS owns two properties, Asset A and Asset B. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset A is $100x and in Asset B is $500x. In Year 1, PRS's section 704(b) depreciation deduction is $10x with respect to Asset A and $5x with respect to Asset B, and DC's section 704(b) distributive share of the depreciation deduction is $8x with respect to Asset A and $1x with respect to Asset B. None of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale. DC's entire distributive share of the depreciation deduction with respect to Asset A and Asset B is allocated and apportioned to gross DEI for Year 1 under § 1.250(b)(1)-1(d)(2).

(B) **Analysis.**—(1) **Sole use partnership property.** Because all of DC's distributive share of the depreciation deduction with respect to Asset A and B is allocated and apportioned to gross DEI for Year 1, Asset A and Asset B are sole use partnership property within the meaning of paragraph (g)(3)(ii)(A) of this section. Therefore, under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset A and Asset B is equal to the sum of DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B for Year 1, multiplied by DC's proportionate share ratio with respect to Asset A and Asset B for Year 1, respectively. Because none of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset A and Asset B is determined entirely by reference to the depreciation deduction with respect to Asset A and Asset B. Therefore, DC's proportionate share ratio with respect to Asset A for Year 1 is 80 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($8x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($10x), DC's proportionate share ratio with respect to Asset B for Year 1 is 20 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($2x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($5x). Accordingly, under paragraph (g)(4)(ii) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A is $80x ($100x × 0.8), and DC's proportionate share of PRS's partnership adjusted basis in Asset B is $500x ($500x × 0.2).

(2) **Proportionate share.** Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B is PRS's partnership adjusted basis in Asset A and Asset B for Year 1, multiplied by DC's proportionate share ratio with respect to Asset A and Asset B for Year 1, respectively. Because none of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset A and Asset B is determined entirely by reference to the depreciation deduction with respect to Asset A and Asset B. Therefore, DC's proportionate share ratio with respect to Asset A for Year 1 is 80 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($8x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($10x), DC's proportionate share ratio with respect to Asset B for Year 1 is 20 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($2x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($5x). Accordingly, under paragraph (g)(4)(ii) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A is $80x ($100x × 0.8), and DC's proportionate share of PRS's partnership adjusted basis in Asset B is $500x ($500x × 0.2).

(3) **Partner adjusted basis.** Because DC has no partner-specific QBAI basis with respect to Asset A and Asset B, DC's partner adjusted basis in Asset A and Asset B is determined
entirely by reference to its proportionate share of PRS’s partnership adjusted basis in Asset A and Asset B. Therefore, under paragraph (g)(3)(iii)(A) of this section, DC’s partner adjusted basis in Asset A is $80x, DC’s proportionate share of PRS’s partnership adjusted basis in Asset A, and DC’s partner adjusted basis in Asset B is $100x, DC’s proportionate share of PRS’s partnership adjusted basis in Asset B.

(4) Partnership QBAI. Under paragraph (g)(2) of this section, DC’s partnership QBAI with respect to Asset A is $180x, the sum of DC’s partner adjusted basis in Asset A ($80x) and DC’s partner adjusted basis in Asset B ($100x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by $180x.

(iii) Example 2: Dual use partnership property—(A) Facts. DC owns a 50 percent interest in PRS. All section 704(b) and tax items are identical and are allocated equally between DC and its other partner. PRS owns three properties, Asset C, Asset D, and Asset E. PRS’s partnership adjusted basis in Product A and Product B. All of DC’s distributive share of the gross income or loss from the sale of Product B is taken into account in determining DC’s DEI, and none of DC’s distributive share of the gross income or loss from the sale of Product B is taken into account in determining DC’s DEI.

(1) Asset C. The average of PRS’s adjusted basis as of the close of each quarter of PRS’s taxable year in Asset C is $100x. In Year 1, PRS’s depreciation is $10x with respect to Asset C, none of which is capitalized to inventory or other property held for sale. DC’s distributive share of the depreciation deduction with respect to Asset C is $5x ($10x × 0.5), $3x of which is allocated and apportioned to DC’s gross DEI under § 1.250(b)–1(d)(2). The amount of the $24x depreciation with respect to Asset E capitalized to inventory of Product A is capitalized to ending inventory. However, of the $12x depreciation with respect to Asset C capitalized to inventory of Product B, $10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset E capitalized to inventory of Product A that is taken into account in determining DC’s distributive share of the income or loss of PRS for Year 1 is $12x ($24x × 0.5), and the amount of depreciation with respect to Asset E capitalized to inventory of Product B that is taken into account in determining DC’s distributive share of the income or loss of PRS for Year 1 is $3x ($6x × 0.5).

(B) Analysis. Because Asset C, Asset D, and Asset E are not used in the production of any gross income or loss for Year 1 within the meaning of paragraph (g)(3)(iii)(B) of this section, Asset C, Asset D, and Asset E are dual use property held for sale, DC’s depreciation with respect to Asset C for Year 1 ($5x), divided by the total amount of PRS’s section 704(b) distributive share of PRS’s partnership adjusted basis in Asset C, Asset D, and Asset E, respectively, for Year 1, multiplied by DC’s dual use ratio with respect to Asset C, Asset D, and Asset E, respectively, for Year 1, determined under paragraph (g)(4)(i) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to DC’s distributive share of the amounts described in paragraph (d)(3) of this section.

(1) Asset C—(i) Proportionate share. Under paragraph (g)(4)(i) of this section, DC’s proportionate share of PRS’s partnership adjusted basis in Asset C is PRS’s partnership adjusted basis in Asset C for Year 1, multiplied by DC’s dual use ratio with respect to Asset C, Asset D, and Asset E, respectively, for Year 1, determined under paragraph (g)(4)(i) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to the depreciation deduction with respect to Asset C for Year 1 ($5x), divided by the total amount of PRS’s section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining DC’s section 704(b) distributive share of PRS’s income or loss for Year 1 ($20x), divided by the total amount of PRS’s section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining DC’s section 704(b) income or loss for Year 1 ($40x). Accordingly, under paragraph (g)(4)(i) of this section, DC’s proportionate share of PRS’s partnership adjusted basis in Asset D is $250x ($500x × 0.5).

(ii) Dual use ratio. Because all of the depreciation with respect to Asset D is capitalized to inventory, DC’s dual use ratio with respect to Asset D is determined entirely by reference to the depreciation with respect to Asset D that is capitalized to inventory and included in cost of goods sold. Therefore, DC’s dual use ratio with respect to Asset D is 25 percent, which is the ratio calculated as the amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC’s DEI for Year 1 ($3x), divided by the total amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC’s income or loss for Year 1 ($20x).

(iii) Partner adjusted basis. Because DC has no partner-specific QBAI basis with respect to Asset D, DC’s partner adjusted basis in Asset D is $30x, DC’s proportionate share of PRS’s partnership adjusted basis in Asset D for Year 1 ($50x), multiplied by DC’s dual use ratio with respect to Asset C. Under paragraph (g)(3)(iii)(A) of this section, DC’s partner adjusted basis in Asset C is $30x, DC’s proportionate share of PRS’s partnership adjusted basis in Asset C for Year 1 ($50x), multiplied by DC’s dual use ratio with respect to Asset C. Under paragraph (g)(3)(iii)(A) of this section, DC’s partner adjusted basis in Asset E is $60x, DC’s proportionate share of PRS’s depreciation deduction with respect to Asset E that is taken into account in determining DC’s distributive share of PRS’s profit or loss for Year 1 ($30x × 0.5), $15x of which is allocated and apportioned to DC’s gross DEI under § 1.250(b)–1(d)(2). The amount of the $24x depreciation with respect to Asset E capitalized to inventory of Product A is capitalized to ending inventory. However, of the $12x depreciation with respect to Asset E capitalized to inventory of Product B, $10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset E capitalized to inventory of Product A that is taken into account in determining DC’s distributive share of the income or loss of PRS for Year 1 is $12x ($24x × 0.5), and the amount of depreciation with respect to Asset E capitalized to inventory of Product B that is taken into account in determining DC’s distributive share of the income or loss of PRS for Year 1 is $3x ($6x × 0.5).
to Asset D, DC’s partner adjusted basis in Asset D is determined entirely by reference to DC’s proportionate share of PRS’s partnership adjusted basis in Asset D, multiplied by DC’s dual use ratio with respect to Asset D. Under paragraph (g)(3)(ii)(A) of this section, DC’s partner adjusted basis in Asset D is 0.5 times ( Asset D is $62.50x, DC’s partner proportionate share of PRS’s partnership adjusted basis in Asset D for Year 1 ($300x), multiplied by DC’s dual use ratio with respect to Asset D for Year 1 (25 percent).

(3) Assumption of partner’s share. Under paragraph (g)(4)(i) of this section, DC’s proportionate share of PRS’s partnership adjusted basis in Asset E is PRS’s partnership adjusted basis in Asset E for Year 1, multiplied by DC’s proportionate share ratio with respect to Asset E for Year 1. Because the depreciation with respect to Asset E is partly deducted and partly capitalized to inventory, DC’s proportionate share ratio with respect to Asset E is determined by reference to both the depreciation that is deducted and partly capitalized to inventory and included in cost of sold goods. Therefore, DC’s proportionate share ratio with respect to Asset E is 50 percent, which is the ratio calculated as the sum ($25x) of the amount of DC’s section 704(b) depreciation deduction share of PRS’s section 704(b) depreciation deduction with respect to Asset E for Year 1 ($10x) and the amount of PRS’s section 704(b) depreciation deduction with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC’s income or loss for Year 1 ($15x).

(iii) Partner adjusted basis. Because DC has no partner-specific QBAI basis with respect to Asset E, DC’s partner adjusted basis in Asset E for Year 1 is determined by reference to DC’s proportionate share of PRS’s partnership adjusted basis in Asset E, multiplied by DC’s dual use ratio with respect to Asset E. Under paragraph (g)(3)(ii)(A) of this section, DC’s partner adjusted basis in Asset E is $20x, DC’s proportionate share of PRS’s partnership adjusted basis in Asset E for Year 1 ($300x), multiplied by DC’s dual use ratio with respect to Asset E for Year 1 (80 percent).

(4) Partnership QBAI. Under paragraph (g)(2) of this section, DC’s partnership QBAI with respect to PRS is $332.50x, the sum of DC’s partner adjusted basis in Asset C ($30x), DC’s partner adjusted basis in Asset D ($62.50x), and DC’s partner adjusted basis in Asset E ($240x). Accordingly, under paragraph (g)(1) of this section, DC incurs its QBAI for Year 1 by $332.50x.

(ii) Example: Sole use partnership specified tangible property; section 743(b) adjustments—(A) Facts. The facts are the same as in paragraph (g)(ii)(A) of this section (the facts in Example 1), except that there is an average of $40x positive adjustment to the adjusted basis in Asset A as of the close of each quarter of PRS’s taxable year with respect to DC under section 743(b) and an average of $20x negative adjustment to the adjusted basis in Asset B as of the close of each quarter of PRS’s taxable year with respect to DC under section 743(b).

(B) Analysis. Under paragraph (g)(3)(ii)(A) of this section, DC’s partner adjusted basis in Asset A is $120x, which is the sum of $80x (DC’s proportionate share of PRS’s partnership adjusted basis in Asset A as illustrated in paragraph (g)(8)(ii)(B)(2) of this section (the analysis in Example 1)) and $40x (DC’s partner-specific QBAI basis in Asset A). Under paragraph (g)(3)(ii)(A) of this section, DC’s partner adjusted basis in Asset B is $80x, the sum of $100x (DC’s proportionate share of the partnership adjusted basis in the property as illustrated in paragraph (g)(8)(ii)(B)(2) of this section (the analysis in Example 1)) and $20x (DC’s partner-specific QBAI basis in Asset B). Therefore, under paragraph (g)(2) of this section, DC’s partnership QBAI with respect to PRS is $200x ($120x + $80x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by $200x.

(v) Example 4: Sale of partnership interest before close of taxable year—(A) Facts. DC1 owns a 50 percent interest in PRS on January 1 of Year 1. PRS does not have an election under section 754 in effect. On July 1 of Year 1, DC1 sells its entire interest in PRS to DC2. PRS owns Asset G. The average of PRS’s adjusted basis in Asset G in the second quarter of PRS’s taxable year in Asset G is $100x. DC1’s section 704(b) distributive share of the depreciation deduction with respect to Asset G is 25 percent with respect to PRS’s entire year. DC2’s section 704(b) distributive share of the depreciation deduction with respect to Asset G is also 25 percent with respect to PRS’s entire year. Both DC1’s and DC2’s entire distributive shares of the depreciation deduction with respect to Asset G are allocated and apportioned under § 1.250(b)–1(d)(2) to DC1’s and DC2’s gross DEI, respectively, for Year 1. PRS’s allocations satisfy section 706(d).

(B) Analysis.—(1) DC1. Because DC1 owns an interest in PRS during DC1’s taxable year and receives a distributive share of (B) Partnership QBAI. Under paragraph (g)(2) of this section, DC’s partnership QBAI with respect to PRS is $20x. Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI by $25x for Year 1.

(2) DC2. DC2’s partner adjusted basis in Asset G is also $25x, the product of $100x (the partnership’s adjusted basis in the property) and 25 percent (DC2’s section 704(b) distributive share of depreciation deduction with respect to Asset G). Therefore, DC1’s partnership QBAI with respect to PRS is $25x. Accordingly, under paragraph (g)(1) of this section, DC2 increases its QBAI by $25x for Year 1.

(vi) Example 5: Partnership adjusted basis; distribution of property in liquidation of partnership interest—(A) Facts. DC1, DC2, and DC3 are equal partners in PRS, a partnership. DC1 and DC2 each has an adjusted basis of $100x in its partnership interest. DC3 has an adjusted basis of $50x in its partnership interest. PRS has a section 754 election in effect. PRS owns Asset H with a fair market value of $50x and an adjusted basis of $0, Asset I with a fair market value of $100x and an adjusted basis of $100x, and Asset J with a fair market value of $150x and an adjusted basis of $150x. Asset H and Asset J are tangible property. PRS distributes Asset I to DC3 in liquidation of DC3’s interest in PRS. None of DC1, DC2, DC3, or PRS recognizes gain on the distribution. Under section 732(b), DC3’s adjusted basis in Asset I is $50x. PRS’s adjusted basis in Asset H is increased by $50x to $50x under section 734(b)(1)(B), which is the amount by which PRS’s adjusted basis in Asset I immediately before the distribution exceeds DC3’s adjusted basis in Asset I.

(B) Analysis. Under paragraph (g)(6) of this section, PRS’s adjusted basis in Asset H is determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)(B) or section 734(b)(2)(A) or 734(b)(2)(A). The adjustment to the adjusted basis in Asset H is under section 734(b)(1)(B) and is attributable to the distribution of Asset J, which is not tangible property. Accordingly, for purposes of applying paragraph (g)(1) of this section, PRS’s adjusted basis in Asset H is $0. 
(b) Anti-avoidance rule for certain transfers of property—(1) In general. If, with a principal purpose of decreasing the amount of its deemed tangible income return, a domestic corporation transfers specified tangible property (transferred property) to a specified related party of the domestic corporation and, within the disqualified period, the domestic corporation or an FDII-eligible related party of the domestic corporation leases the same or substantially similar property from any specified related party, then, solely for purposes of determining the QBAI of the domestic corporation under paragraph (b) of this section, the domestic corporation is treated as owning the transferred property from the later of the beginning of the term of the lease or date of the transfer of the property until the earlier of the end of the term of the lease or the end of the recovery period of the property.

(2) Rule for structured arrangements. For purposes of paragraph (b)(1) of this section, a transfer of specified tangible property to a person that is not a related party or lease of property from a person that is not a related party is treated as a transfer to or lease from a specified related party if the transfer or lease is pursuant to a structured arrangement. A structured arrangement exists only if either paragraph (b)(2)(i) or (ii) of this section is satisfied.

(i) The reduction in the domestic corporation's deemed tangible income return is priced into the terms of the arrangement with the transferee.

(ii) Based on all the facts and circumstances, the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement. Facts and circumstances that indicate the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement include—

(A) Marketing the arrangement as tax-advantaged where some or all of the tax advantage derives from the reduction in the domestic corporation's deemed tangible income return;

(B) Primarily marketing the arrangement to domestic corporations which earn FDII;

(C) Features that alter the terms of the arrangement, including the return, in the event the reduction in the domestic corporation's deemed tangible income return is no longer relevant; or

(D) A below-market return absent the tax effects or benefits resulting from the reduction in the domestic corporation's deemed tangible income return.

(b)(1) of this section, a transfer of property by a domestic corporation to a specified related party (including a party deemed to be a specified related party under paragraph (b)(2) of this section) followed by a lease of the same or substantially similar property by the domestic corporation or an FDII-eligible related party from a specified related party (including a party deemed to be a specified related party under paragraph (b)(2) of this section) is treated per se as occurring pursuant to a principal purpose of decreasing the amount of the domestic corporation's deemed tangible income return if both the transfer and the lease occur within a six-month period.

(4) Definitions related to anti-avoidance rule. The following definitions apply for purpose of this paragraph (b).

(i) Disqualified period. The term disqualified period means, with respect to a transfer, the period beginning one year before the date of the transfer and ending the earlier of the end of the remaining recovery period of the property (under the system described in section 951A(d)(3)(A)) of the property or one year after the date of the transfer.

(ii) FDII-eligible related party. The term FDII-eligible related party means, with respect to a domestic corporation, a member of the same consolidated group as the domestic corporation or a partnership with respect to which at least 80 percent of the interests in partnership capital and profits are owned, directly or indirectly, by the domestic corporation or one or more members of the consolidated group that includes the domestic corporation.

(iii) Specified related party. The term specified related party means, with respect to a domestic corporation, a related party other than an FDII-eligible related party.

(iv) Transfer. The term transfer means any disposition, exchange, contribution, or distribution of property, and includes an indirect transfer. For example, a transfer of an interest in a partnership is treated as a transfer of the assets of the partnership. In addition, if paragraph (b)(1) of this section applies to treat a domestic corporation as owning specified tangible property by reason of a lease of property, the termination or lapse of the lease of the property is treated as a transfer of the specified tangible property by the domestic corporation to the lessor.

(5) Transactions occurring before March 4, 2019. Paragraph (b)(1) of this section does not apply to a transfer of property that occurs before March 4, 2019.

(6) Examples. The following examples illustrate the application of this paragraph (b).

(i) Example 1: Sale-leaseback with a related party—(A) Facts. Domestic corporation DC, owns Asset A. DC, which is a FDII-eligible related party, leases Asset A to FS2. The terms of the sale of Asset A to FS2, which is substantially similar to Asset A, to FS2 for a five-year term ending on January 31, Year 6.

(B) Analysis. Because DC is a FDII-eligible related party and FS2, a specified related party, leases Asset A from DC, DC is treated as owning Asset A from January 31, Year 6, the later of the date of lease of Asset A (January 1, Year 6) and the beginning of the term of the lease of Asset A (February 1, Year 6).

(ii) Example 2: Sale-leaseback with a related party—(A) Facts. Domestic corporation DC, a FDII-eligible related party, leases Asset A, which is substantially similar property (Asset B) to FS2. DC's transfer of Asset A and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from February 1, Year 1, the later of the date of the transfer of Asset A (January 1, Year 1) and the beginning of the term of the lease of Asset B (February 1, Year 1), until January 31, Year 6, the earlier of the end of the term of the lease of Asset B (January 31, Year 6) or the remaining recovery period of Asset A (December 31, Year 10).

(iii) Example 3: Sale-leaseback with a related party; lapse of initial lease—(A) Facts. The facts are the same as in paragraph (b)(6)(i)(A) of this section (the facts in Example 1). In addition, DS allows the lease of Asset B to expire on February 1, Year 6. On June 1, Year 6, DS and FS2 renew the lease for a five-year term ending on May 31, Year 11.

(B) Analysis. Because DC is treated as owning Asset A under paragraph (b)(1) of this section, the lapse of the lease of Asset B is treated as a transfer of Asset B to FS2 on February 1, Year 6, under paragraph (b)(2)(iv) of this section. Further, because DC is deemed to transfer specified tangible property (Asset A) to a specified related party (FS2) upon the lapse of the lease, and within a six month period (February 1, Year 6 to June 1, Year 6), an FDII-eligible related party of DS (DS) leases a substantially similar property (Asset B), DC's deemed transfer of Asset A under paragraph (b)(4)(iv) of this section and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from June 1, Year 6, the later of the date of the deemed transfer of Asset A (February 1, Year 6) and the beginning of the term of the lease of Asset B (June 1, Year 6), until December 31, Year 10, the earlier of the end of the term of the lease

Example 1: Sale-leaseback with a related party—(A) Facts. Domestic corporation DC, owns Asset A. DC, which is a FDII-eligible related party, leases Asset A to FS2. The terms of the sale of Asset A to FS2, which is substantially similar to Asset A, to FS2 for a five-year term ending on January 31, Year 6.

(B) Analysis. Because DC is a FDII-eligible related party and FS2, a specified related party, leases Asset A from DC, DC is treated as owning Asset A from January 31, Year 6, the later of the date of lease of Asset A (January 1, Year 6) and the beginning of the term of the lease of Asset A (February 1, Year 6).

(ii) Example 2: Sale-leaseback with a related party—(A) Facts. Domestic corporation DC, a FDII-eligible related party, leases Asset A, which is substantially similar property (Asset B) to FS2. DC's transfer of Asset A and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from February 1, Year 1, the later of the date of the transfer of Asset A (January 1, Year 1) and the beginning of the term of the lease of Asset B (February 1, Year 1), until January 31, Year 6, the earlier of the end of the term of the lease of Asset B (January 31, Year 6) or the remaining recovery period of Asset A (December 31, Year 10).

(iii) Example 3: Sale-leaseback with a related party; lapse of initial lease—(A) Facts. The facts are the same as in paragraph (b)(6)(i)(A) of this section (the facts in Example 1). In addition, DS allows the lease of Asset B to expire on February 1, Year 6. On June 1, Year 6, DS and FS2 renew the lease for a five-year term ending on May 31, Year 11.

(B) Analysis. Because DC is treated as owning Asset A under paragraph (b)(1) of this section, the lapse of the lease of Asset B is treated as a transfer of Asset B to FS2 on February 1, Year 6, under paragraph (b)(2)(iv) of this section. Further, because DC is deemed to transfer specified tangible property (Asset A) to a specified related party (FS2) upon the lapse of the lease, and within a six month period (February 1, Year 6 to June 1, Year 6), an FDII-eligible related party of DS (DS) leases a substantially similar property (Asset B), DC's deemed transfer of Asset A under paragraph (b)(4)(iv) of this section and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from June 1, Year 6, the later of the date of the deemed transfer of Asset A (February 1, Year 6) and the beginning of the term of the lease of Asset B (June 1, Year 6), until December 31, Year 10, the earlier of the end of the term of the lease
of Asset B (May 31, Year 11) or the remaining recovery period of Asset A (December 31, Year 10).

§1.250(b)–3 Foreign-derived deduction eligible income (FDDEI) transactions.

(a) Scope. This section provides rules related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (b) of this section provides definitions related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (c) of this section provides rules regarding a sale of property or provision of a service to a foreign government or an agency or instrumentality thereof. Paragraph (d) of this section provides a rule for characterizing a transaction with both sales and services elements. Paragraph (e) of this section provides a rule for determining whether a sale of property or provision of a service to a partnership is a FDDEI transaction. Paragraph (f) of this section provides rules for substantiating certain FDDEI transactions.

(b) Definitions. This paragraph (b) provides definitions that apply for purposes of this section and §§1.250(b)–4 through 1.250(b)–6.

(1) Digital content. The term digital content means a computer program or any other content in digital format. For example, digital content includes books in digital format, movies in digital format, and music in digital format. For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer or other electronic device in order to bring about a certain result, and includes any media, user manuals, documentation, data base, or similar item if the media, user manuals, documentation, data base, or other similar item is incidental to the operation of the computer program.

(2) End user. Except as modified by §1.250(b)–4(d)(2)(ii), the term end user means the person that ultimately uses or consumes property or a person that acquires property in a foreign retail sale. A person that acquires property for resale or otherwise as an intermediary is not an end user.

(3) FDII filing date. The term FDII filing date means, with respect to a sale of property by a seller or provision of a service by a renderer, the date, including extensions, by which the seller or renderer is required to file an income tax return (or in the case of a seller or renderer that is a partnership, a return of income) for the taxable year in which the gross income from the sale of property or provision of a service is included in the gross income of the seller or renderer.

(4) Finished goods. The term finished goods means general property that is acquired by an end user.

(5) Foreign person. The term foreign person means a person (as defined in section 7701(a)(11)) that is not a United States person and includes a foreign government or an international organization.

(6) Foreign related party. The term foreign related party means, with respect to a seller or renderer, any foreign person that is a related party of the seller or renderer.

(7) Foreign retail sale. The term foreign retail sale means a sale of general property to a recipient that acquires the general property at a physical retail location (such as a store or warehouse) outside the United States.

(8) Foreign unrelated party. The term foreign unrelated party means, with respect to a seller, a foreign person that is not a related party of the seller.

(9) Fungible mass of general property. The term fungible mass of general property means multiple units of property for sale with similar or identical characteristics for which the seller does not know the specific identity of the recipient or the end user for a particular unit.

(10) General property. The term general property means any property other than: Intangible property (as defined in paragraph (b)(11) of this section); a security (as defined in section 475(c)(2)); an interest in a partnership, trust, or estate; a commodity; or a commodity described in section 475(e)(2)(A) that is not a physical commodity; a commodity described in section 475(e)(2)(B) through (D). A physical commodity described in section 475(e)(2)(A) is treated as general property, including if it is sold pursuant to a forward or option contract (including a contract described in section 475(e)(2)(C)), but not a section 1256 contract as defined in section 1256(b) or other similar contract that is traded on a U.S. or non-U.S. regulated exchange and cleared by a central clearing organization in a manner similar to a section 1256 contract that is physically settled by delivery of the commodity (provided that the taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances).

(11) Intangible property. The term intangible property has the meaning set forth in section 367(d)(4). For purposes of section 250, intangible property does not include a copyrighted article as defined in §1.861–18(c)(3).

(12) International transportation property. The term international transportation property means aircraft, railroad rolling stock, vessel, motor vehicle, or similar property that provides a mode of transportation and is capable of traveling internationally.

(13) IP address. The term IP address means a device’s internet Protocol address.

(14) Recipient. The term recipient means a person that purchases property or services from a seller or renderer.

(15) Renderer. The term renderer means a person that provides a service to a recipient.

(16) Sale. The term sale means any sale, lease, license, sublicense, exchange, or other disposition of property, and includes any transfer of property in which gain or income is recognized under section 367. In addition, the term sell (and any form of the word sell) means any transfer by sale.

(17) Seller. The term seller means a person that sells property to a recipient.

(18) United States. The term United States has the meaning set forth in section 7701(a)(9), as expanded by section 638(1) with respect to mines, oil and gas wells, and other natural deposits.

(19) United States person. The term United States person has the meaning set forth in section 7701(a)(30), except that the term does not include an individual that is a bona fide resident of a United States territory within the meaning of section 937(a).

(20) United States territory. The term United States territory means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.

(21) Foreign military sales and services. If a sale of property or a provision of a service is made to the United States or an instrumentality thereof pursuant to 22 U.S.C. 2751 et seq. under which the United States or an instrumentality thereof purchases the property or service for resale or on-service to a foreign government or agency or instrumentality thereof, then the sale of property or provision of a service is treated as a FDDEI sale or FDDEI service without regard to §1.250(b)–4 or §1.250(b)–5.

(d) Transactions with multiple elements. A transaction is classified according to its overall predominant character for purposes of determining whether the transaction is a FDDEI sale or a FDDEI service under §1.250(b)–5. For example, whether a transaction that includes both
a sales component and a service component is subject to § 1.250(b)-4 or § 1.250(b)-5 is determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale or service. In addition, whether a transaction that includes both a sale of general property and a sale of intangible property is subject to § 1.250(b)-4(d)(1) or § 1.250(b)-4(d)(2) is determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale of general property or a sale of intangible property.

(e) Treatment of partnerships—(1) In general. For purposes of determining whether a sale of property to or by a partnership or a provision of a service to or by a partnership is a FDDEI transaction, a partnership is treated as a person. Accordingly, for example, a partnership may be a seller, renderer, recipient, or related party, including a foreign related party (as defined in paragraph (b)(6) of this section).

(2) Examples. The following examples illustrate the application of this paragraph (e).

(i) Example 1: Domestic partner sale to foreign partnership with a foreign branch—(A) Facts. DC, a domestic corporation, is a partner in PRS, a foreign partnership. DC and PRS are not related parties. PRS has a foreign branch within the meaning of § 1.904–4(f)(3)(iii). DC and PRS both use the calendar year as their taxable year. For the taxable year, DC recognizes $20x of gain on the sale of general property to PRS for a foreign use (as determined under § 1.250(b)-4(d)). During the same taxable year, PRS recognizes $20x of gain on the sale of other general property to a foreign person for a foreign use (as determined under § 1.250(b)-4(d)). PRS’s income on the sale of the property is attributable to its foreign branch.

(B) Analysis. DC’s sale of property to PRS, a foreign partnership, is a FDDEI sale because it is a sale to a foreign person for a foreign use. Therefore, DC’s gain of $20x on the sale to PRS is included in DC’s gross DEI and gross FDDEI. However, PRS’s gain of $20x is not included in the gross DEI or gross FDDEI of PRS because the gain is foreign branch income within the meaning of § 1.250(b)-1(c)(11). Accordingly, none of PRS’s gain on the sale of property is included in DC’s gross DEI or gross FDDEI under § 1.250(b)-1(e)(1).

(ii) Example 2: Domestic partner sale to domestic partnership without a foreign branch—(A) Facts. The facts are the same as in paragraph (e)(2)(i)(A) of this section (the facts in Example 1), except PRS is a domestic partnership that does not have a foreign branch within the meaning of § 1.904–4(f)(3)(iii).

(B) Analysis. DC’s sale of property to PRS, a domestic partnership, is not a FDDEI sale because the sale is to a United States person. Therefore, the gross income from DC’s sale to PRS is included in DC’s gross DEI but is not included in its gross FDDEI. However, PRS’s sale of other general property is a FDDEI sale, and therefore the gain of $20x is included in the gross DEI and gross FDDEI of PRS. Accordingly, DC includes its distributive share of PRS’s gain from the sale in determining DC’s gross FDDEI for the taxable year under § 1.250(b)-1(e)(1).

(f) Substantiation for certain FDDEI transactions—(1) In general. Except as provided in paragraph (f)(2) of this section, for purposes of § 1.250(b)-4(d)(1)(i)(C) (foreign use for sale of general property for resale), § 1.250(b)-4(d)(1)(ii)(B) (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), § 1.250(b)-4(d)(2) (foreign use for sale of intangible property), and § 1.250(b)-5(e) (general services provided to business recipients located outside the United States), a transaction is a FDDEI transaction only if the taxpayer substantiates its determination of foreign use (in the case of sales of property) or location outside the United States (in the case of general services provided to a business recipient) as described in the applicable paragraphs of § 1.250(b)-4(d)(3) or § 1.250(b)-5(e)(4). The substantiating documents must be in existence as of the FDI filing date with respect to the FDDEI transaction, and a taxpayer must provide the required substantiating documents within 30 days of a request by the Commissioner or another period as agreed between the Commissioner and the taxpayer.

(2) Exception for small businesses. Paragraph (f)(1) of this section, and the specific substantiation requirements described in the applicable paragraph of § 1.250(b)-4(d)(3) or § 1.250(b)-5(e)(4), do not apply to a taxpayer if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than $25,000,000 in gross receipts during the taxable year prior to the FDDEI transaction. If the taxpayer’s prior taxable year was less than 12 months (a short period), gross receipts are annualized by multiplying the gross receipts for the short period by 365 and dividing the result by the number of days in the short period.

(3) Treatment of certain loss transactions—(i) In general. If a domestic corporation fails to satisfy the substantiation requirements described in the applicable paragraph of § 1.250(b)-4(d)(3) or § 1.250(b)-5(e)(4) with respect to a transaction (including in connection with a related party transaction described in § 1.250(b)-6), the gross income from the transaction will be treated as gross FDDEI if—

(A) In the case of a sale of property, the seller knows or has reason to know that property is sold to a foreign person for a foreign use (within the meaning of § 1.250(b)-4(d)(1) or (2));

(B) In the case of the provision of a general service to a business recipient, the renderer knows or has reason to know that a service is provided to a business recipient located outside the United States; and

(C) Not treating the transaction as a FDDEI transaction would increase the amount of the corporation’s FDDEI for the taxable year relative to its FDDEI that would be determined if the transaction were treated as a FDDEI transaction.

(ii) Reason to know—(A) Sales to a foreign person for a foreign use. For purposes of paragraph (f)(3)(i)(A) of this section, a seller has reason to know that a sale is to a foreign person for a foreign use if the information received as part of the sales process contains information that indicates that the recipient is a foreign person or that the sale is for a foreign use. A seller fails to obtain evidence establishing that the recipient is not in fact a foreign person or that the sale is not in fact for a foreign use. Information that indicates that a recipient is a foreign person or that the sale is for a foreign use includes, but is not limited to, a foreign phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed outside the United States.

(B) General services provided to a business recipient located outside the United States. For purposes of paragraph (f)(3)(i)(B) of this section, a renderer has reason to know that the provision of a general service is to a business recipient located outside the United States if the information received as part of the sales process contains information that indicates that the recipient is a business recipient located outside the United States and the seller fails to obtain evidence that the recipient is not in fact a business recipient located outside the United States. Information that indicates that a recipient is a business recipient includes, but is not limited to, indicia of a business status (such as “LLC” or “Company,” or similar indicia applicable to the sale of intangible property outside the United States) or location outside the United States.

(4) Substantiation for certain domestic FDDEI transactions.
(iii) Multiple transactions. If a seller or renderer engages in more than one transaction described in paragraph (f)(3)(i) of this section in a taxable year, paragraph (f)(3)(i) of this section applies by comparing the corporation’s FDDEI if each such transaction were not treated as a FDDEI transaction to its FDDEI if each such transaction were treated as a FDDEI transaction.

(iv) Example. The following example illustrates the application of this paragraph (f)(3).

(A) Facts. During a taxable year, DC, a domestic corporation, manufactures products A and B in the United States. DC sells product A and product B to Y, a foreign person that is a distributor, for $200x and $800x, respectively. DC knows or has reason to know that all of its sales of product A and product B will ultimately be sold to end users located outside the United States. Y provides DC with a statement that satisfies the substantiation requirement of paragraph (f)(1) of this section and § 1.250(b)–4(d)(3)(ii) that establishes that its sales of product B are for a foreign use but does not obtain substantiation establishing that any sales of product A are for a foreign use. DC’s cost of goods sold is $450x. For purposes of determining gross FDDEI, under § 1.250(b)–1(d)(1) DC attributes $250x of cost of goods sold to product A and $200x of cost of goods sold to product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of each product sold to foreign persons and the gross receipts of such product not sold to foreign persons.

The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction.

<table>
<thead>
<tr>
<th>Table 1 to Paragraph (f)(3)(iv)(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product A</td>
</tr>
<tr>
<td>-----------</td>
</tr>
<tr>
<td>$200x</td>
</tr>
<tr>
<td>250x</td>
</tr>
<tr>
<td>(50x)</td>
</tr>
</tbody>
</table>

(B) Analysis. By not treating the sales of product A as FDDEI sales, the amount of DC’s FDDEI would increase by $50x relative to its FDDEI if the sales of product A were treated as FDDEI sales. Accordingly, because DC knows or has reason to know that its sales of product A are to foreign persons for a foreign use, the sales of product A constitute FDDEI sales under paragraph (f)(3) of this section, and thus the $50x loss from the sale of product A is included in DC’s gross FDDEI.

§ 1.250(b)–4 Foreign-derived deduction eligible income (FDDEI) sales.

(a) Scope. This section provides rules for determining whether a sale of property is a FDDEI sale. Paragraph (b) of this section defines a FDDEI sale. Paragraph (c) of this section provides rules for determining whether a recipient is a foreign person. Paragraph (d) of this section provides rules for determining whether property is sold for a foreign use. Paragraph (e) of this section provides a special rule for the sale of interests in a disregarded entity. Paragraph (f) of this section provides a rule regarding certain hedging transactions with respect to FDDEI sales.

(b) Definition of FDDEI sale. Except as provided in § 1.250(b)–6(c), the term FDDEI sale means a sale of general property of intangible property to a recipient that is a foreign person (see paragraph (c) of this section for determination of foreign person status) and that is for a foreign use (as determined under paragraph (d) of this section). A sale of any property other than general property or intangible property is not a FDDEI sale.

(c) Presumption of foreign person status—(1) In general. The sale of property is presumed to be to a recipient that is a foreign person for purposes of paragraph (b) of this section if the sale is described in paragraph (c)(2) of this section. However, this presumption does not apply if the seller knows or has reason to know that the sale is not to a foreign person. A seller has reason to know that a sale is not to a foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. Information that indicates that a recipient is not a foreign person include, but are not limited to, a United States phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed in the United States.

(2) Sales of property. A sale of a property is described in this paragraph (c)(2) if:

(i) The sale is a foreign retail sale;

(ii) In the case of a sale of general property that is not a foreign retail sale and the general property is delivered (such as through a commercial carrier) to the recipient or an end user, the shipping address of the recipient or end user is inside the United States;

(iii) In the case of a sale of general property that is not described in either paragraph (c)(2)(i) or (ii) of this section, the billing address of the recipient is inside the United States; or

(iv) In the case of a sale of intangible property, the billing address of the recipient is outside the United States.

(d) Foreign use—(1) Foreign use for general property—(i) In general. The sale of general property for a foreign use for purposes of paragraph (b) of this section if the seller determines that the sale is for a foreign use under the rules of paragraph (d)(1)(i) or (iii) of this section and the exception in paragraph (d)(1)(iv) of this section does not apply.

(ii) Rules for determining foreign use—(A) Sales that are delivered to an end user by a carrier or freight forwarder. Except as otherwise provided in this paragraph (d)(1)(ii)(A), a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) that is delivered through a carrier or freight forwarder to a recipient that is an end user is for a foreign use if the end user receives delivery of the general property outside the United States. However, a sale described in the preceding sentence is not treated as a sale to an end user for a foreign use if the sale is made with a principal purpose of having the property transported from its location outside the United States to a location within the United States for ultimate use or consumption.

(B) Sales to an end user without the use of a carrier or freight forwarder. With respect to sales that are not delivered through the use of a carrier or freight forwarder, a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) to a recipient that is an end user is for a foreign use if the property is located outside the United States at the time of the sale (including as part of foreign retail sales).

(C) Sales for resale. A sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) to a recipient (such as a distributor or retailer) that will resell the general property is for a foreign use if the
general property will ultimately be sold to end users outside the United States (including in foreign retail sales) and such sales to end users outside the United States are substantiated under paragraph (d)(3)(ii) of this section. In the case of sales of a fungible mass of general property, the taxpayer may presume that the proportion of its sales that are ultimately sold to end users outside the United States is the same as the proportion of the recipient's resales of that fungible mass to end users outside the United States. (D) Sales of digital content. A sale of general property that primarily contains digital content that is transferred electronically rather than in a physical medium is for a foreign use if the end user downloads, installs, receives, or accesses the purchased digital content on the end user's device outside the United States (see §1.250(b)–5(d)(2) and (e)(2)(iii) for rules that apply in the case of digital content that is not purchased in a sale but is electronically supplied as a service). If information about where the digital content is downloaded, installed, received, or accessed (such as the device's IP address) is unavailable, and the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than $50,000, a sale of general property described in the preceding sentence is for a foreign use if it is to an end user that has a billing address located outside the United States. (E) Sales of international transportation property used for compensation or hire. A sale of international transportation property used for compensation or hire is for a foreign use if the end user registers the property with a foreign jurisdiction. (f) Sales of international transportation property not used for compensation or hire. A sale of international transportation property not used for compensation or hire is for a foreign use if the end user registers the property in a foreign jurisdiction and hangs or stores the property primarily outside the United States. (iii) Sales for manufacturing, assembly, or other processing—(A) In general. A sale of general property is for a foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the United States and such manufacturing, assembly, or other processing outside the United States is substantiated under paragraph (d)(3)(iii) of this section. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (as described in paragraph (d)(1)(iii)(B) of this section) or the property is incorporated as a component into another product (as described in paragraph (d)(1)(iii)(C) of this section). (B) Property subject to a physical and material change. The determination of whether general property is subject to a physical and material change is made based on all the relevant facts and circumstances. General property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state. (C) Property incorporated into a product as a component. General property is a component incorporated into another product if the incorporation of the general property into another product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances. However, general property is not considered a component incorporated as a component into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. In addition, general property is treated as a component if the seller expects, using reliable estimates, that the fair market value of the property when it is delivered to the recipient will constitute no more than 20 percent of the fair market value of the finished good into which the general property is directly or indirectly incorporated when the finished good is sold to end users (the "20-percent rule"). If the property could be incorporated into a number of different finished goods, a reliable estimate of the fair market value of the finished good may include the average fair market value of a representative range of such goods. For purposes of the 20-percent rule, all general property that is sold by the seller and incorporated into the finished good is treated as a single item of property if the seller sells the property to the recipient and the seller knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). A seller knows or has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product and the seller fails to obtain evidence to the contrary. (iv) Sales of property subject to manufacturing, assembly, or other processing in the United States. If the seller sells general property to a recipient (other than a related party) for manufacturing, assembly, or other processing within the United States, such property is not sold for a foreign use even if the requirements of paragraph (d)(1)(ii) or (iii) of this section are subsequently satisfied.
some tablets incorporating the batteries may be sold to an end user in the United States. DC’s sale of batteries is considered for a foreign use. Accordingly, DC’s sale of batteries to FP is for a foreign use under paragraph (d)(1)(ii)(C) of this section and is considered a FDDEI sale.

(2) Example 2: Manufacturing outside the United States—(i) Facts. The facts are the same as in paragraph (d)(1)(v)(B)(1) of this section (the facts in Example 1), except FP purchases the batteries from DC for $25x. In addition, FP purchases other components of tablets from other parties. FP has a substantial investment in machinery and tools that are used to assemble tablets.

(ii) Analysis. Even though the fair market value of the batteries that FP purchases from DC and incorporates into the tablets exceeds 20 percent of the fair market value of the tablets, because the batteries are used by FP in activities that are substantial in nature and generally considered to constitute the manufacture, assembly or other processing of property, the retailers only sell components of the tablets. As a result, DC’s sale of property to FP IS still for a foreign use under paragraph (d)(1)(iii)(A) and (C) of this section, and the sale is a FDDEI sale.

(3) Example 3: Sale of products to distributor outside the United States—(i) Facts. DC sells smartphones to FP, a distributor of electronics located within Country A. The sales contract between DC and FP provides that FP may sell the smartphones it purchases from DC only to specified retailers located within Country A. The smartphones sold to FP do not include any electronics, including smartphones, in foreign retail sales.

(ii) Analysis. Although FP does not sell the smartphones it purchases from DC to end users, FP sells to retailers that sell the smartphones in foreign retail sales. All of the sales of smartphones from DC to FP are sales of general property for a foreign use under paragraph (d)(1)(iii)(C) of this section because FP is only allowed to sell the smartphones to retailers who sell such property in foreign retail sales. DC’s sales of smartphones to FP are FDDEI sales.

(4) Example 4: Sale of a fungible mass of products—(i) Facts. DC and persons other than DC sell multiple units of printer paper that is considered fungible general property to FP during the taxable year. FP is a distributor that sells paper to retail stores within and outside the United States. FP informs DC that approximately 25 percent of FP’s sales of the paper are to retail stores located outside of the United States for foreign retail sales.

(ii) Analysis. The sale of paper to FP is for a foreign use to the extent that the paper will be sold to end users located outside the United States under paragraph (d)(1)(iii)(C) of this section. Because a portion of DC’s sales to FP are not for a foreign use, DC must determine the portion of paper that is sold for a foreign use. Based on the information provided by FP about its own sales, DC determines under paragraph (d)(1)(iii)(C) of this section that 25 percent of the total units of paper that is fungible general property that FP purchased from all persons in the taxable year will ultimately be sold to end users located outside the United States. Accordingly, DC satisfies the test for a foreign use under paragraph (d)(1)(iii)(C) of this section with respect to 25 percent of its sales of the paper to FP.

(5) Example 5: Limited use license of copyrighted computer software—(i) Facts. DC provides FP with a limited use license to copyrighted computer software in exchange for an annual fee of $100x. The limited use license restricts FP’s use of the computer software to 100 of FP’s employees, who download the software onto their computers. The limited use license prohibits FP from using the computer software in any way other than as an end user, which includes prohibiting sublicensing, selling, reverse engineering, or modifying the computer software. All of FP’s employees download the software onto computers that are physically located outside the United States.

(ii) Analysis. The software licensed to FP is digital content as defined in §1.250(b)-3(b)(3), and is downloaded by an end user as defined in §1.250(b)-3. Accordingly, because the software is downloaded solely onto computers outside the United States, DC’s license to FP for a foreign use and therefore a FDDEI sale under paragraph (d)(1)(iii)(D) of this section. The entire $100x of the license fee is included in DC’s gross FDDEI for the taxable year.

(6) Example 6: Limited use license of copyrighted computer software used within and outside the United States—(i) Facts. The facts are the same as in paragraph (d)(1)(v)(B)(5) of this section (the facts in Example 5). FP has offices both within and outside the United States, and DC’s internal records indicate that 50 percent of the downloads of the software are onto computers located outside the United States.

(ii) Analysis. Because 50 percent of the downloads of the software are onto computers located outside the United States, a portion of DC’s license to FP is for a foreign use and therefore such portion is a FDDEI sale. The $50x of license fee derived with respect to such portion is included in DC’s gross FDDEI for the taxable year.

(7) Example 7: Sale of a copyrighted article—(i) Facts. DC sells copyrighted music available for download on its website. Once downloaded, the recipient listens to the music acquired through the music service being performed. Such a service is considered a sale of a copyrighted article, and thus is a sale of general property. See §1.250(b)-3(b)(10) and (11). As a result, the sale is considered for a foreign use under paragraph (d)(1)(iii)(D) of this section because the digital content was installed, received, or accessed on the end user’s device outside the United States. The income derived with respect to the sale of the music is included in DC’s gross FDDEI for the taxable year. See §1.250(b)-5(d)(3) for an example of digital content provided to consumers as a service rather than as a sale.

(2) Foreign use for intangible property—(i) In general. A sale of rights to exploit intangible property solely outside the United States is for a foreign use. A sale of rights to exploit intangible property solely within the United States is not for a foreign use. A sale of rights to exploit intangible property worldwide is partially for a foreign use and partially not for a foreign use.

Whether intangible property is exploited within versus outside the United States is determined based on revenue earned from end users located within versus outside the United States. Therefore, a sale of rights to exploit intangible property both within and outside the United States is for a foreign use in proportion to the revenue earned from end users located outside the United States over the revenue earned from the exploitation of the intangible property. A sale of intangible property will be treated as a FDDEI sale only if the substantiation requirements of paragraph (d)(3)(iv) of this section are satisfied. For rules specific to determining end users and revenue earned from end users for intangible property used in sales of general property, provision of services, research and development, or consisting of a manufacturing method or process, see paragraph (d)(2)(ii) of this section.

(ii) Determination of end users and revenue earned from end users—(A) Intangible property embedded in general property or used in connection with the sale of general property. If intangible property is embedded in general property that is sold, or used in connection with a sale of general property, then the end user of the intangible property is the end user of the general property. Revenue is earned from the end user of the general property outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1)(iii)(C) of this section.

(B) Intangible property used in providing a service. If intangible property is used to provide a service, then the end user of that intangible property is the recipient, consumer, or business recipient of the service or, in the case of a property service or a transportation service that involves the transportation of property, the end user is the owner of the property on which such service is being performed. Such end users are treated as if the service is provided outside the United States only to the extent the service qualifies as a FDDEI service.
under § 1.250(b)–5. Therefore, in the case of a recipient of a sale of intangible property that uses such intangible property to provide a property service that qualifies as a FDDEI service to another person, that person is the end user and is treated as located outside the United States.

(C) Intangible property consisting of a manufacturing method or process—(1) In general. Except as provided in paragraph (d)(2)(ii)(C)(2) of this section, if intangible property consists of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(3) of this section) and is sold to a foreign unrelated party (including in a sale by a foreign related party), then the foreign unrelated party is treated as an end user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end user located within the United States. A seller has reason to know that the manufacturing method or process will be used in the United States if the information received from the recipient indicates that the recipient intends to use the manufacturing method or process in the United States and the seller fails to obtain evidence establishing that the recipient does not intend to use the manufacturing method or process in the United States.

(2) Exception for certain manufacturing arrangements. A sale of intangible property consisting of a manufacturing method or process (including a sale by a foreign related party) to a foreign unrelated party for use in manufacturing products for or on behalf of the seller or any person related to the seller does not qualify as a sale to a foreign unrelated party for purposes of determining the end user under paragraph (d)(2)(ii)(C)(1) of this section.

(3) Manufacturing method or process. For purposes of this section, a manufacturing method or process consists of a sequence of actions or steps that comprise an overall method or process that is used to manufacture a product or produce a particular manufacturing result, which may be in the form of a patent or know-how. Intangible property consisting of the right to make and sell an item of property is not a manufacturing method or process, whereas intangible property consisting of the right to apply a series of actions or steps to be performed to achieve a particular manufacturing result is a manufacturing method or process. For example, a utility or design patent on an article of manufacture, machine, composition of matter, design, or providing the right to sell equipment to perform a process is not a manufacturing method or process, whereas a utility patent covering a method or process of manufacturing is a manufacturing method or process for purposes of this section.

(D) Intangible property used in research and development. If intangible property (primary IP) is used to develop new or modify other intangible property (secondary IP), then the end user of the primary IP is the end user (applying paragraph (d)(2)(ii)(A), (B), or (C) of this section) of the secondary IP.

(iii) Determination of revenue for periodic payments versus lump sums—(A) Sales in exchange for periodic payments. In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, to a recipient in exchange for periodic payments, the extent to which the sale is for a foreign use is determined annually based on the actual revenue earned by the recipient from any use of the intangible property for the taxable year in which a periodic payment is received. If actual revenue earned by the recipient cannot be obtained after reasonable efforts, then estimated revenue earned by a recipient that is not a related party of the seller from the use of the intangible property may be used based on the principles of paragraph (d)(2)(ii)(A), (B), or (C) of this section.

(B) Sales in exchange for a lump sum. In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, for a lump sum, the extent to which the sale is for a foreign use is determined based on the ratio of the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property outside the United States to the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property. In the case of a recipient that is a foreign unrelated party, net present values of revenue that the recipient expected to earn from the exploitation of the intangible property within and outside the United States may also be used if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. Net present values must be determined using reliable inputs including, but not limited to, reliable revenue, expenses, and discount rates. The extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor in determining whether such inputs are reliable. If the intangible property is sold to a foreign related party, the reliability of the inputs used to determine net present values and the net present values are determined under section 482.

(C) Sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process. In the case of a sale to an unrelated foreign party of intangible property consisting of a manufacturing method or process, the revenue earned from the intangible property consisting of the manufacturing method or process equals the total amount paid for the bundled sale multiplied by the proportion that the value of the manufacturing method or process bears to the total value of the intangible property. The value of the manufacturing method or process to the total value of the intangible property must be determined using the principles of section 482.

(iv) Examples. The following examples illustrate the application of this paragraph (d)(2).

(A) Assumed facts. The following facts are assumed for purposes of the examples—

(1) DC is a domestic corporation.

(2) Except as otherwise provided, FP and FP2 are foreign persons that are foreign unrelated parties with respect to DC.

(3) All of DC’s income is DEI.

(4) Except as otherwise provided, the substantiation requirements described in paragraph (d)(3)(iv) of this section are satisfied.

(5) Except as otherwise provided, inputs used to determine the net present values of the revenue are reliable.

(B) Examples—

(1) Example 1: License of worldwide rights with actual revenue data from recipient—(i) Facts. DC licenses to FP worldwide rights to the copyright to composition A in exchange for annual royalties of 60 percent of revenue from FP’s sales of composition A. FP sells composition A to customers through digital downloads from servers. In the taxable year, FP earns $100x in revenue from sales of
copies of composition A to customers, of which $60x is from customers located in the United States and the remaining $40x is from customers located outside the United States. FP provides DC with reliable records showing the amount of revenue earned in the taxable year from sales of composition A to establish the royalties owed to DC. These records also provide DC with the amount of revenue earned from sales of composition A to customers located within the United States.

(ii) Analysis. FP is not the end user of the copyright to composition A under paragraph (d)(2)(ii)(A) of this section because the copyright is used in the sale of general property (the sale of copyrighted articles to customers). The customers that purchase a copy of composition A from FP are the end users (as defined in §1.250(b)(3)-b(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the recipients of composition A when sold as general property. Based on the actual revenue earned by FP from composition A, 40 percent ($40x/$100x) of the revenue generated by the copyright during the taxable year is earned outside the United States. Accordingly, a portion of DC's license to FP is for a foreign use under paragraph (d)(2)(ii)(A) of this section and therefore such portion is a FDDEI sale. The $24x of royalty ($40x/$100x of total royalties owed to DC during the taxable year) derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(2) Example 2: Fixed annual payments for worldwide rights to composition A without actual revenue data from recipient—(i) Facts. The facts are the same as in paragraph (d)(2)(iv)(B)(1) of this section (the facts in Example 1), except FP pays DC a fixed annual payment of $860x each year for the worldwide rights to the copyright to composition A and does not provide DC with data showing how much revenue FP earned from sales of composition A, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from sales of composition A to customers located within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC's economic analysis of the revenue DC expected it could earn annually from use of composition A as part of determining the annual payments DC would receive from FP from the license of composition A supports a determination that 40 percent of sales of composition A during the tax year would be to customers located outside the United States. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of composition A used in determining the amount of annual payments agreed to by DC and FP.

(ii) Analysis. For the same reasons provided in paragraph (d)(2)(ii)(B)(1)(ii) of this section (the analysis in Example 1), the customers that purchase copies of composition A from FP are the end users. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from the use of the copyright to composition A under paragraph (d)(2)(ii)(A) of this section because DC was unable to obtain actual revenue earned by FP from use of the copyright to composition A during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC's economic analysis, a portion of DC's license to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. $24x of the $60x fixed payment to DC ($40x/$100x) is included in DC's gross FDDEI for the taxable year.

(3) Example 3: Sale of patent rights protected in the United States and other countries; use of financial projections in sale to foreign unrelated party—(i) Facts. DC owns a patent for an active pharmaceutical ingredient ("API") approved for treatment of disease A ("disease A") in the United States and in Countries A, B, and C. The patent is registered in the United States and in Countries A, B, and C. DC sells to FP all of its patent rights to the API for indication A for a lump sum payment of $1,000x. DC has no basis in the patent rights. To determine the sales price for the patent rights, DC projected that the net present value of the revenue it would earn from selling a pharmaceutical product incorporating the API for indication A was $5,000x, with 15 percent of the net present value of revenue earned from sales within the United States and 85 percent of the net present value of revenue earned from sales outside the United States. DC did not obtain revenue projections from the recipient.

(ii) Analysis. FP is not the end user of the patent to composition A under paragraph (d)(2)(ii)(A) of this section because the patent is used in the sale of general property (the sale of pharmaceutical products to customers) and FP is not the recipient of that general property. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in §1.250(b)(3)-b(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the recipients of composition A when sold as general property. Based on the financial projections DC used to determine the sales price for the patent, DC's economic analysis would result in 1 percent of the revenue earned from sales within the United States and 99 percent of the revenue earned from sales outside the United States. During the examination of DC's return for the taxable year, the IRS determines that DC's substantiation allocating the projected revenue from sales within the United States and outside the United States does not reflect reliable inputs to determine the net present values of revenue under section 482, but determines that the total lump sum price FP paid for DC's patent rights is an arm's length price. The IRS determines that the reliable net present values of revenue DC would have earned from sales within the United States and outside the United States is $750x and $4250x, respectively.

(iii) Analysis. For the same reasons provided in paragraph (d)(2)(iv)(B)(1) of this section (the analysis in Example 3), the customers that purchase the finished pharmaceutical product from FP are the end users. Under paragraph (d)(2)(ii)(B) of this section, the reliability of the inputs DC used to determine the net present values and the net present values are determined under section 482. Based on the sales price of the patent that FP purchased and the IRS-determined net present values of revenue DC would have earned from sales within the United States and outside the United States, a portion of DC's sale to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. DC is allowed to include $850x ($4250x divided by $750x x $4250x) of gain in DC's gross FDDEI for the taxable year.

(5) Example 5: Sale of patent rights protected in the United States and other countries; foreign unrelated party—(i) Facts. DC owns the worldwide rights to a patent covering a manufacturing process for refining crude oil. DC sells to FP the rights to manufacture a pharmaceutical product incorporating the API for indication A was $5,000x, with 15 percent of the net present value of revenue earned from sales within the United States and 85 percent of the net present value of revenue earned from sales outside the United States. DC did not obtain revenue projections from the recipient.

(ii) Analysis. DC's patent covering a manufacturing process for refining crude oil is a manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(3) of this section. Under paragraph (d)(2)(ii)(C) of this section, FP is treated as the end user of the patent, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that FP will use the patented process to refine crude oil within the United States or will sell or license the rights to the patent to a person to refine crude oil within the United States.

(iii) Analysis. DC's patent covering a manufacturing process for refining crude oil is a manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(3) of this section. Under paragraph (d)(2)(ii)(C) of this section, FP is treated as the end user of the patent, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that the patented process will be used in the United States. As a result, all of the sale to FP for a foreign use under paragraph (d)(2) of this section and therefore is a FDDEI sale. The entire $100x lump sum payment is included in DC's gross FDDEI for the taxable year.

(6) Example 6: License of intangible property that includes a patented manufacturing method or process protected in the United States and other countries; foreign unrelated party—(i) Facts. DC owns worldwide rights to patents, know-how, and a trademark and tradename for product Z. The patents consist of: a patent covering the right to make, use, and sell product Z (article of manufacture), a patent covering the rights to make, use, and sell a composition of substances used in certain components of product Z (composition of matter), and a patent covering the right to use a manufacturing process consisting of a series
of manufacturing steps to manufacture product Z (manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(3) of this section) and to sell the product Z that FP manufactures using the manufacturing method or process. The know-how consists entirely of the know-how used to implement the manufacturing steps that comprise the manufacturing method or process. DC licenses the worldwide rights to the patents, know-how, and the trademark and trade name for product Z to FP in exchange for annual royalties of 60 percent of revenue from sales of product Z. FP manufactures product Z in country X and sells product Z to DC2, a domestic corporation and unrelated party to DC and FP, for resale to customers located within the United States. FP also sells product Z to FP2, a foreign unrelated party with respect to DC and FP, for resale to customers located outside the United States. During the taxable year, FP sells to DC2 $140x of product Z. Also, during the taxable year, FP sells to FP2 $60x of product Z.

(i) Analysis—(A) End users. Under paragraph (d)(2)(ii)(C)(1) of this section, FP is treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process, and is treated as located outside the United States. DC licenses the worldwide rights to the intangible property and the manufacturing method or process to FP. FP is a foreign unrelated party to DC. DC determines under the principles of section 482 that the licensed know-how and the patented manufacturing method or process comprise 10 percent of the arm’s length price of the intangible property. DC licenses to FP.

(ii) Analysis—(A) End users. Under paragraph (d)(2)(ii)(C)(1) of this section, FP is treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process, and is treated as located outside the United States. DC licenses the worldwide rights to the intangible property and the manufacturing method or process to FP. FP is a foreign unrelated party to DC. DC determines under the principles of section 482 that the licensed know-how and the patented manufacturing method or process comprise 10 percent of the arm’s length price of the intangible property.

(b) Foreign use. Based on the sales of product Z to customers located within and outside the United States, $72x of the royalties FP pays DC for rights to the licensed intangible property during the taxable year (($120x of revenue from sales to customers located outside the United States divided by $200x total worldwide sales revenue) × $120x total royalties) qualifies as income earned from the sale of intangible property for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. As a result, $72x of royalties is included in DC’s gross FDDEI for the taxable year.

Example 8: Deemed sale in exchange for contingent payments under section 367(d)(1)–(i) Facts. DC owns 100 percent of the stock of FP, a foreign related party with respect to DC. FP manufactures and sells product A. For the taxable year, DC contributes to FP exclusive worldwide rights to patents, trademarks, know-how, customer lists, and goodwill and going concern value of FP’s global assets. Product A is a silicon chip used in computers, tablets, and smartphones. DC licenses to FP the intangible property related to product A in an exchange described in section 351. DC is required to report an annual income inclusion on its Federal income tax return based on the productivity, use, or disposition of the contributed intangible property under section 367(d). DC includes a percentage of FP’s revenue in its gross income under section 367(d) each year. In the current taxable year, FP earns $1,000x of revenue from sales of product A. Based on reliable sales records kept by FP for the taxable year, $300x of FP’s revenue is earned from sales of product A located within the United States, and $700x of its revenue is earned from sales of product A to customers outside the United States.

(ii) Analysis. DC’s deemed sale of the intangible property to FP in exchange for payments contingent upon the productivity, use, or disposition of the intangible property related to product A under section 367(d) is a sale for purposes of section 250 and this section. See § 1.250(b)–3(b)(16). Based on FP’s sales records for the taxable year, 70 percent of DC’s deemed sale is earned from sales of product A located within the United States, and 70 percent of DC’s income inclusion under section 367(d) derived with respect to such portion is included in DC’s gross FDDEI for the taxable year.

Example 9: License of intangible property followed by a sale of goodwill in which the intangible property is embedded; unrelated parties—(i) Facts. DC owns the worldwide rights to a patent on a silicon chip used in computers, tablets, and smartphones. The patent does not qualify as a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(3) of this section). DC licenses the worldwide rights to the patent to FP in exchange for annual royalties of 30 percent of revenue from sales of the silicon chips. During the taxable year, FP manufactures silicon chips protected by the patent and sells all of those silicon chips to a third party for $1,000x. Still, FP2 also purchases similar silicon chips from other suppliers. FP2 uses the silicon chips in computers, tablets, smartphones, and motherboards that FP2 manufactures in country X and sells to its customers located within the United States and foreign countries. For purposes of this
example, FP2’s manufacturing qualifies as
subjecting the silicon chips to manufacture,
assembled, or other processing outside the
United States as provided in paragraph (d)(1)(iii) of this section.

(ii) Analysis. FP is not the end user or
treated as an end user (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because FP is not the unrelated party recipient of the general property in which the patent is embedded, and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users located outside the United States to the extent the sale of the general property is for a foreign use. Revenue from royalties paid for the patent is from sales to unrelated party wholesalers that qualify as foreign use under paragraph (d)(1) of this section and the sales to the unrelated party manufacturers qualify as foreign use under paragraph (d)(1)(iii) of this section. Accordingly, revenue from royalties pays to DC during the taxable year is included in DC’s gross FDDEI for the taxable year.

Example 10: License of intangible property followed by a sale of general property in which the intangible property is embedded; related parties—(i) Facts. The facts are the same as in paragraph (d)(2)(iv)(B)(9)(i) of this section (the facts in Example 9), except that FP and FP2 are foreign related parties with respect to DC. FP2 sells and ships computers, tablets, and smartphones with the silicon chips it purchases from FP to unrelated party wholesalers located within and outside the United States. The wholesalers within the United States only sell to retailers located within the United States and the wholesalers outside the United States only sell to retailers located outside the United States. The retailers within the United States only sell to customers located within the United States and the retailers located outside the United States only sell to customers located outside the United States. Revenue from sales to unrelated party wholesalers located outside the United States and $10,000x of revenue from sales to unrelated party wholesalers located within the United States. FP2 also sells and ships motherboards with the silicon chips it purchases from FP to unrelated party manufacturers located outside the United States. FP2 does not sell motherboards with the silicon chips it purchases from FP to unrelated party manufacturers located within the United States. FP2 earns $5,000x of revenue from sales to unrelated party wholesalers located outside the United States and $10,000x of revenue from sales to unrelated party wholesalers located within the United States.

(ii) Analysis. FP is not the end user or
treated as an end user (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP is not the end user of the general property in which the patent is embedded (the silicon chips). FP2 is also not the end user (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP2 is not the end user of the silicon chips. Under paragraph (d)(2)(ii)(A) of this section, the customers of the retailers that purchase from the unrelated party wholesalers are the end users. Because the wholesalers located outside the United States only sell to retailers located outside the United States that sell to end users located outside the United States, the location of the wholesalers is a reliable basis for determining the location of the end users. Revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. A portion of the sales to the unrelated party wholesalers qualify as foreign use under paragraph (d)(1) of this section and the sales to the unrelated party manufacturers qualify as foreign use under paragraph (d)(1)(iii) of this section. Accordingly, revenue from royalties pays to DC during the taxable year is included in DC’s gross FDDEI for the taxable year.

Example 11: License of intangible property; related parties with manufacturing within the United States—(i) Facts. The facts are the same as in paragraph (d)(2)(iv)(B)(9)(i) of this section (the facts in Example 9), except that FP2 manufactures its computers, tablets, smartphones, and motherboards in the United States. The facts are the same as in paragraph (d)(2)(ii)(A) of this section) because FP is not the end user or treated as an end user (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP is not the end user of the general property in which the patent is embedded, and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users located outside the United States to the extent the sale of the general property is for a foreign use. Revenue from royalties paid for the patent is from sales to unrelated party wholesalers that qualify as foreign use under paragraph (d)(1) of this section and the sales to the unrelated party manufacturers qualify as foreign use under paragraph (d)(1)(iii) of this section. Accordingly, revenue from royalties pays to DC during the taxable year is included in DC’s gross FDDEI for the taxable year.

Example 12: License of intangible property used to provide a service—(i) Facts. DC licenses to FP worldwide rights to the copyrights on movies in exchange for an annual royalty of $100x. FP also licenses copyrights on movies from persons other than DC. FP provides a streaming service that meets the definition of an electronically supplied service in § 1.250(b)–5(c)(5) to its customers within the United States and foreign countries. FP’s streaming service provides its customers a catalog of movies to choose from to stream. These movies include the copyrighted movies FP licenses from DC. FP does not provide DC with data showing how much revenue FP earned from streaming services during the taxable year, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from streaming services to customers within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC’s economic analysis of the revenue DC expected it could earn annually from use of the copyrights as part of determining the annual payments DC would receive from FP is the license of the copyrights supports a determination that $10,000x of revenue would be earned during the taxable year from customers worldwide and that 40 percent of that revenue would be earned from customers located outside the United States. During an examination of DC’s return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of the copyrights used in determining the amount of annual payments agreed to by DC and FP.

(ii) Analysis. Under paragraph (d)(2)(ii)(B) of this section, FP’s customers are the end users of the copyrights. FP uses those copyrights to provide the general service to FP’s customers. Under paragraph (d)(2)(ii)(B) of this section, revenue from royalties paid for the copyrights is earned from end users outside the United States to the extent the service qualifies as a FDDEI service under § 1.250(b)–5. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from streaming the licensed movies under paragraph (d)(2)(iii)(A) of this section because DC was unable to obtain actual revenue earned by FP from the copyrights during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC’s reliable economic analysis, $40x of the annual royalty payment to DC (0.4 × $100x total annual royalty payment) is included in DC’s gross FDDEI for the taxable year.
sales of finished pharmaceutical products containing the API during years 1 through 4 of the license of patent A. In year 5 of the license of patent A, FP earns $800x of revenue from sales of finished pharmaceutical products containing the API to customers located within the United States and $200x of revenue from sales to customers located in foreign countries.

(ii) Analysis. FP is not the end user (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(D) of this section) of patent A because FP is not the end user described in paragraph (d)(2)(ii)(A) of this section of the product in which the API that was developed from patent A is embedded. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(D) of this section) because those customers are the end users described in paragraph (d)(2)(ii)(A) of this section of the pharmaceutical product in which the newly developed patent is embedded. During the taxable years that include years 1 through 4 of the license of patent A, FP earns no revenue from sales of the API to a foreign person for a foreign use. Under paragraph (d)(2)(ii)(D) of this section, none of the $300x annual royalty payments to DC for each of the tax years that include none of the $100x annual royalty payments is included in DC’s gross FDDEI. Based on FP’s sales of the API during the tax year that includes year 5 of the license of patent A, $20x of the annual royalty payment to DC ($200x of revenue from sales of API to customers located outside the United States divided by $1,000x total worldwide revenue earned from sales of the API) × $100x annual royalty) is included in DC’s gross FDDEI for the taxable year.

(3) Foreign use substantiation for certain sales of property—(i) In general. Except as provided in § 1.250(b)–3(f)(3) (relating to certain loss transactions), a sale of property described in paragraphs (d)(1)(ii)(C) of this section (foreign use for sale of general property for resale), (d)(1)(iii) of this section (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), or (d)(2) of this section (foreign use for sale of intangible property) is a FDDEI transaction only if the taxpayer satisfies the substantiation requirements described in paragraphs (d)(3)(i), (d)(3)(ii), or (d)(3)(iii) of this section, as applicable.

(ii) Substantiation of foreign use for resale. A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(ii)(C) of this section (sales of general property for resale) only if the seller maintains one or more of the following items—

(A) A binding contract that specifically limits subsequent sales to sales outside the United States;

(B) A description of how the property is specifically designed, labeled, or adapted for a foreign market;

(C) Proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical that the property will be resold in the United States;

(D) Credible evidence obtained or created in the ordinary course of business from the recipient evidencing that property will be sold to an end user outside the United States (or, in the case of sales of fungible mass property, stating what portion of the property will be sold to end users outside the United States);

(E) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iii)(E)(1) through (7) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(1) The name and address of the recipient;

(2) The date or dates the property was shipped or delivered to the recipient;

(3) The amount of gross income from the sale;

(4) A full description of the property subject to resale;

(5) A description of the method of sales to the end users, such as direct sales by the recipient or sales by the recipient to retail stores;

(6) If known, a description of the end users; and

(7) A description of how the seller determined that property will be ultimately sold to an end user outside the United States (or, in the case of sales of fungible mass property, of how the taxpayer determined what portion of the property that will ultimately be sold to end users outside the United States).

(iii) Substantiation of foreign use for manufacturing, assembly, or other processing outside the United States. A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(iii) of this section (sales of general property subject to manufacturing, assembly, or other processing outside the United States) if the seller maintains one or more of the following items—

(A) Credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and such property generally cannot be sold to end users without being subject to a physical and material change (for example, the sale of raw materials that cannot be used except in a manufacturing process);

(B) Credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the United States; or

(C) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iv)(C)(1) through (7) of this section.
through (9) of this section corroborated by evidence that is credible and sufficient to support the information provided.
(1) The name and address of the recipient;
(2) The date of the sale;
(3) The amount of gross income from the sale;
(4) A description of the intangible property;
(5) An explanation of how the intangible property will be used by the recipient (embedded in general property, used to provide a service, used as a manufacturing method or process, or used in research and development);
(6) An explanation of how the seller determined what portion of the sale is a FDDEI sale;
(7) If the intangible property consists of a manufacturing method or process, an explanation of how the elements of paragraph (d)(2)(ii)(C) of this section are satisfied;
(8) If the sale is for periodic payments, an explanation of how the seller determined the extent of foreign use based on the actual revenue earned by the recipient from the use of the intangible property for the taxable year in which a periodic payment is received as required by paragraph (d)(2)(ii)(A) of this section, or, if actual revenue cannot be obtained after reasonable efforts, an explanation of why actual revenue is unavailable and how the seller determined the extent of foreign use based on estimated revenue; and
(9) If the sale is for a lump sum, an explanation of how the seller determined the total net present value of revenue it expected to earn from the exploitation of the intangible property outside the United States and the total net present value of revenue it expected to earn from the exploitation of the intangible property as required by paragraph (d)(2)(ii)(B) of this section.

(v) Examples. The following examples illustrate the application of this paragraph (d)(3).

(A) Assumed facts. The following facts are assumed for purposes of the examples—
(1) DC is a domestic corporation.
(2) FP is a foreign person located within Country A that is a foreign unrelated party with respect to DC.
(3) All of DC’s income is DEI.
(4) Except as otherwise provided, the substantive rule for foreign use as described in paragraphs (d)(1) and (2) of this section are satisfied.

(B) Examples—
(1) Example 1: Substantiation by seller of sale of products to distributor outside the United States with taxpayer statement and corroborating evidence—(i) Facts. DC sells smartphones to FP, a distributor of electronics that sells property to end users. As part of their regular business process and pursuant to DC’s terms and conditions of sales, DC issues commercial invoices to FP that contain a condition that any subsequent sales must be to end users outside the United States. At or near the time of the FDII filing date, DC prepares a statement containing the information required in paragraph (d)(3)(ii)(E) of this section. During an examination of DC’s return for the taxable year, the IRS requests substantiation of foreign use. DC submits the commercial invoices issued to FP as supporting information that FP’s customers are end users outside the United States and all other corroborating evidence to the IRS.

(ii) Analysis. DC’s sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirement by providing the statement that satisfies the requirements of paragraph (d)(3)(ii)(E) of this section. The commercial invoices issued pursuant to the terms and conditions of sales sufficiently corroborate DC’s statement that the smartphones will ultimately be sold to end users outside of the United States.

(2) Example 2: Substantiation of sale of products to distributor outside the United States with recipient provided information—(i) Facts. DC sells cameras to FP, a distributor of electronics that sells property to end users outside the United States. FP issues sales invoices to its end users. The invoices contain detailed information about the nature of the subsequent sales of the cameras and the location of the end users for value added tax (VAT) purposes. DC is able to obtain copies of FP’s VAT invoices with respect to the camera sales that were maintained and submitted pursuant to Country A law. Rather than prepare a statement described in paragraph (d)(3)(ii)(E) of this section, DC submits FP’s invoices to the IRS as substantiation of foreign use.

(ii) Analysis. DC’s sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirements by providing the invoices that satisfy the requirements of paragraph (d)(3)(ii)(D) of this section. The VAT invoices issued by FP pursuant to Country A law constitute credible evidence from FP that ultimate sales are to end users located outside the United States.

(e) Sales of interests in a disregarded entity. Under Federal income tax principles, the sale of any interest in an entity that is disregarded for Federal income tax purposes is considered the sale of the assets of that entity, and this section applies to the sale of each such asset that is general property or intangible property for purposes of determining whether such sale qualifies as a FDDEI sale.

(f) FDDEI sales hedging transactions—(1) In general. The amount of a corporation’s or partnership’s gross FDDEI from FDDEI sales of general property in a taxable year is increased by any gain, or decreased by any loss, taken into account in that taxable year with respect to any FDDEI sales hedging transactions (determined by taking into account the applicable Federal income tax accounting rules, including §1.1446–4).

(2) FDDEI sales hedging transaction—The term FDDEI sales hedging transaction means a transaction that meets the requirements of §1.1221–2(a) through (e) and that is identified in accordance with the requirements of §1.1221–2(f), except that the transaction must manage risk of price changes or currency fluctuations with respect to ordinary property, as provided in §1.1221–2(b)(1), and the ordinary property whose price risk is being hedged must be general property that is sold in a FDDEI sale.

§1.250(b)–5 Foreign-derived deduction eligible income (FDDEI) services.

(a) Scope. This section provides rules for determining whether a provision of a service is a FDDEI service. Paragraph (b) of this section defines a FDDEI service. Paragraph (c) of this section provides definitions relevant for determining whether a provision of a service is a FDDEI service. Paragraph (d) of this section provides rules for determining whether a general service is provided to a consumer located outside the United States. Paragraph (e) of this section provides rules for determining whether a general service is provided to a recipient located outside the United States. Paragraph (f) of this section provides rules for determining whether a proximate service is provided to a consumer located outside the United States. Paragraph (g) of this section provides rules for determining whether a service is provided with respect to property located outside the United States. Paragraph (h) of this section provides rules for determining whether a transportation service is provided to a recipient, or with respect to property, located outside the United States.

(b) Definition of FDDEI service. Except as provided in §1.250(b)–6(d), the term FDDEI service means a provision of a service described in any one of paragraphs (b)(1) through (5) of this section. If only a portion of a service is treated as provided to a person, or with respect to property, outside the United States, the provision of the service is a FDDEI service only to the extent of the gross income derived with respect to such portion.

(1) The provision of a general service to a consumer located outside the United States (as determined under paragraph (d) of this section).
(2) The provision of a general service to a business recipient located outside the United States (as determined under paragraph (e) of this section).

(3) The provision of a proximate service to a recipient located outside the United States (as determined under paragraph (f) of this section).

(4) The provision of a property service with respect to tangible property located outside the United States (as determined under paragraph (g) of this section).

(5) The provision of a transportation service to a recipient, or with respect to property, located outside the United States (as determined under paragraph (h) of this section).

(c) Definitions. This paragraph (c) provides definitions that apply for purposes of this section and § 1.250(b)-6.

(1) Advertising service. The term advertising service means a general service that consists primarily of transmitting or displaying content (including via the internet) to consumers with a purpose to generate revenue based on the promotion of a product or service.

(2) Benefit. The term benefit has the meaning set forth in § 1.482-9(l)(3).

(3) Business recipient. The term business recipient means a recipient other than a consumer and includes all related parties of the recipient. However, if the recipient is a related party of the taxpayer, the term does not include the taxpayer.

(4) Consumer. The term consumer means a recipient that purchases a general service for personal use.

(5) Electronically supplied service. The term electronically supplied service means, with respect to a general service other than an advertising service, a service that is delivered primarily over the internet or an electronic network. Electronically supplied services include the provision of access to digitized products (such as streaming content without downloading the content); on-demand network access to computing resources, such as networks, servers, storage, and software; the provision or support of a business or personal presence on a network (such as a website or a web page); services automatically generated from a computer via the internet or other network in response to data input by the recipient; the provision of information electronically; and similar services.

(6) General service. The term general service means any service other than a property service, proximate service, or transportation service. The term general service includes advertising services and electronically supplied services.

(7) Property service. The term property service means a service, other than a transportation service, provided with respect to tangible property, but only if substantially all of the service is performed at the location of the property and results in physical manipulation of the property such as through manufacturing, assembly, maintenance, or repair. Substantially all of a service is performed at the location of property only if the renderer spends more than 80 percent of the time providing the service at or near the location of the property.

(8) Proximate service. The term proximate service means a service, other than a property service or a transportation service, provided to a consumer or business recipient, but only if substantially all of the service is performed in the physical presence of the consumer or, in the case of a business recipient, substantially all of the service is performed in the physical presence of persons working for the business recipient such as employees, contractors, or agents. Substantially all of a service is performed in the physical presence of a consumer or persons working for a business recipient only if the renderer spends more than 80 percent of the time providing the service in the physical presence of such persons.

(9) Transportation service. The term transportation service means a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any other mode of transportation. Transportation services include freight forwarding and similar services.

(d) General services provided to consumers—(1) In general. A general service is provided to a consumer located outside the United States if the consumer of a general service resides outside the United States when the service is provided. Except as provided in paragraph (d)(2) of this section, if the renderer does not have or cannot after reasonable efforts obtain the consumer’s location of residence when the service is provided, the consumer of a general service is treated as residing at the location of the consumer’s billing address. However, the rule in the preceding sentence allowing for the use of a consumer’s billing address does not apply if the renderer knows or has reason to know that the consumer does not reside outside the United States. A renderer has reason to know that the consumer does not reside outside the United States if the information received in the provision of the service indicates that the consumer resides in the United States and the renderer fails to obtain evidence establishing that the consumer resides outside the United States.

(2) Electronically supplied services. The consumer of an electronically supplied service is deemed to reside at the location of the device used to receive the service. Such location may be determined based on the location of the IP address when the electronically supplied service is provided. However, if the renderer does not have or cannot after reasonable efforts obtain the consumer’s device location, then the location of the device is treated as being outside the United States if the renderer’s billing address for the consumer is outside of the United States, subject to the knowledge and reason to know standards described in paragraph (d)(1) of this section.

(3) Example. The following example illustrates the application of paragraph (d)(1) of this section.

(i) Facts. DC, a domestic corporation, provides a streaming movie service on its website. The terms of the service allow consumers to watch movies over the internet. The terms of the service permit the consumer to view the movies for personal use, but convey no ownership of movies to the consumers.

(ii) Analysis. The streaming service is a FDDEI service under paragraph (d)(1) of this section to the extent that the service is provided to consumers that reside outside the United States. The service that DC provides is a general service, provided to consumers that is an electronically supplied service under paragraph (c)(5) of this section. Therefore, the consumers are deemed to reside at the location of the devices used to receive the service under paragraph (d)(2) of this section. However, if the renderer cannot reasonably obtain the consumers’ device location (such as IP addresses), the device location is treated as being outside the United States if their billing addresses are outside the United States. See § 1.250(b)-4(d)(1)(v)(B)(7) for an example of digital content provided to consumers as a sale rather than a service.

(e) General services provided to a business recipient—(1) In general. A general service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on the business recipient’s operations outside the United States under the rules in paragraph (e)(2) of this section. The location of residence, incorporation, or formation of a business recipient is not relevant to determining the location of the business recipient’s operations that benefit from a general service.

(2) Determination of business operations that benefit from the service—(b) In general. Except as otherwise provided in paragraph (e)(2)(ii) and (iii) of this section, the
determination of which operations of the business recipient located outside the United States benefit from a general service, and the extent to which such operations benefit, is made under the principles of § 1.482–9 by treating the taxpayer as one controlled taxpayer, the portions of the business recipient’s operations within the United States (if any) that may benefit from the general service as one or more controlled taxpayers, and the portions of the business recipient’s operations outside the United States (if any) that may benefit from the general service, each as one or more controlled taxpayers. The extent to which a business recipient’s operations within or outside of the United States are treated as one or more separate controlled taxpayers is determined under any reasonable method (for example, separate controlled taxpayers may be determined on a per entity or per country basis, or by aggregating all of the business recipient’s operations outside the United States as one controlled taxpayer). The determination of the amount of the benefit conferred on the business recipient’s operations that are treated as controlled taxpayers is determined under a reasonable method consistent with the principles of § 1.482–9(k), treating the renderer’s gross income from the services provided to the business recipient as if it were a “cost” as that term is used in § 1.482–9(k). Reasonable methods may include, for example, allocations based on time spent or costs incurred by the renderer or sales, profits, or assets of the business recipient. Determination is made when the service is provided based on information obtained from the business recipient or on the renderer’s own records (such as time spent working with the business recipient’s offices located outside the United States). (ii) Advertising services. With respect to advertising services, the operations of the business recipient that benefit from the advertising services provided by the renderer are deemed to be located where the advertisements are viewed by individuals. If advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. For this purpose, the IP address may be used to establish the location of a device on which an advertisement is viewed.

(iii) Electronically supplied services. With respect to an electronically supplied service, the operations of the business recipient that benefit from that service provided by the renderer are deemed to be located where the business recipient (including employees, contractors, or agents) accesses the service. If it cannot be determined whether the location is within or outside the United States (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services with respect to the business recipient are in the aggregate less than $50,000 for the renderer’s taxable year, the operations of the business recipient that benefit from the service provided by the renderer are deemed to be located at the recipient’s billing address; otherwise, the operations of the business recipient that benefit is deemed to be located in the United States. If the renderer provides a service that is partially an electronically supplied service and partially a general service that is not an electronically supplied service (such as a service that is performed partially online and partially by mail or in person), the location of the business recipient is determined using the rule for electronically supplied services in this paragraph (e)(2)(ii) if the primary purpose of the service is to provide electronically supplied services; otherwise, the rule for general services described in paragraph (e)(2)(i) of this section applies.

(3) Identification of business recipient’s operations—(i) In general. For purposes of this paragraph (e), except with respect to advertising services and electronically supplied services, a business recipient is treated as having operations where it maintains an office or other fixed place of business. In general, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. For purposes of making the determination in this paragraph (e)(3)(i), the renderer may make reliable assumptions based on the information available to it.

(ii) Advertising services and electronically supplied services. The location of a business recipient that receives advertising services or electronically supplied services will be determined under the rules of paragraph (e)(2)(ii) and (iii) of this section, respectively, even if the business recipient does not maintain an office or other fixed place of business in the locations where the advertisements are viewed (in the case of advertising services) or where the general service is accessed (in the case of electronically supplied services).

(iii) No office or fixed place of business. In the case of general services other than advertising services and other than electronically supplied services, if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address.

(4) Substantiation of the location of a business recipient’s operations outside the United States. Except as provided in § 1.250(b)–3(f)(3) (relating to certain loss transactions), a general service provided to a business recipient is treated as a FDDEI service only if the renderer substantiates its determination of the extent to which the service benefits a business recipient’s operations outside the United States. A renderer satisfies the preceding sentence if the renderer maintains one or more of the following items—

(i) Credible evidence obtained or created in the ordinary course of business from the business recipient establishing the extent to which operations of the business recipient outside the United States benefit from the service; or

(ii) A written statement prepared by the renderer containing the information described in paragraphs (e)(4)(ii)(A) through (F) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(A) The name of the business recipient;

(B) The date or dates of the service;

(C) The amount of gross income from the service;

(D) A full description of the service;

(E) A description of how the service will benefit the business recipient; and

(F) An explanation of how the renderer determined what portion of the service will benefit the business recipient’s operations located outside the United States.

(5) Examples. The following examples illustrate the application of this paragraph (e).

(i) Assumed facts. The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.

(B) A and R are not related parties of DC.

(C) Except as otherwise provided, the substantiation requirements described in paragraph (e)(4) of this section are satisfied.

(ii) Examples—

(A) Example 1: Determination of business operations that benefit from the service—(1) Facts. For the taxable year, DC provides a consulting service to R, a company that operates restaurants within and outside of
the United States, in exchange for $150x. Fifty percent of the sales earned by R and its related parties are from customers located outside of the United States. However, the consulting service that DC provides relates specifically to a single chain of fast food restaurants. Sales information that R provides to DC indicates that 70 percent of the sales of the fast food restaurant chain are from locations within the United States and 30 percent of the sales are from Country X. DC determines that the use of sales is a reasonable method. R’s fast food operations outside the United States and a FDDEI service under paragraph (b)(2) of this section, as modified by paragraph (e)(2)(iii) of this section, R’s operations outside the United States are deemed to be located where R accesses the service, which is where R’s employees access the website. See paragraph (e)(2)(iii) of this section. Accordingly, the portion of the payroll service that is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section is determined based on the extent to which the locations where R accesses the website are located outside the United States. Because 60 percent (60/100) of user accounts access DC’s website from locations outside the United States, 60 percent of the provision of the payroll service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(F) Example 6: Electronically supplied services that are accessed by the business recipient’s customers—(1) Facts. DC maintains a website for R, a company that sells consumer goods online. R’s offices are in the United States, but R sells its products to customers both within and outside the United States. Based on the IP addresses of the devices on which the website is accessed, 30 percent of the devices that accessed the website during the taxable year were located outside the United States.

(2) Analysis. Under paragraph (e)(1) of this section, DC’s service is provided to a person located outside the United States to the extent that DC’s service confers a benefit to R’s operations located outside the United States. Under paragraph (e)(2)(i) of this section, DC’s service is accessed, which is where R’s operations located outside the United States are deemed to be located. Therefore, 30 percent of the provision of the service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(E) Example 5: Electronically supplied services that are accessed by the business recipient’s employees—(1) Facts. DC provides payroll services for R. As part of this service, DC maintains a website through which R can enter payroll information for its employees and through which R’s employees can enter and change their personal information. DC also causes R’s employees’ paychecks to be directly deposited into their bank accounts and pays R’s employment taxes on R’s behalf. The primary purpose of the service is to pay R’s employees. R has 100 user accounts that access DC’s website. Sixty of the user accounts that access DC’s website access the website from devices that are located outside the United States and forty of the user accounts access the website from devices that are located inside the United States.

(2) Analysis. Under paragraph (e)(1) of this section, DC’s service is provided to a person located outside the United States to the extent that DC’s service confers a benefit to R’s operations outside the United States. The service that DC provides to R is an electronically supplied service under paragraph (c)(5) of this section. Accordingly, under paragraph (e)(2)(i) of this section, DC’s service is provided to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section is determined based on the extent to which the locations where R accesses the service are located outside the United States. Because 60 percent (60/100) of user accounts access DC’s website from locations outside the United States, 60 percent of the provision of the payroll service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(D) Example 4: No reliable information about which operations benefit from the service or publicly available information—(1) Facts. For the taxable year, DC provides a consulting service to R, a business-facing company that does not advertise its business. All of DC’s interaction with R is through R’s employees that report to an office in the United States. Statements made by R’s employees indicate that the service will benefit R’s business operations located within and outside the United States, but do not provide any information that DC can use to reliably determine the extent to which its service will confer a benefit on R’s business operations located outside the United States.

(2) Analysis. DC is unable to determine the extent to which its service will confer a benefit on R’s business operations located outside the United States. Under paragraph (e)(2)(iii) of this section, R’s operations outside the United States are deemed to be located where R accesses the service, which is where R’s employees access the website. Therefore, 30 percent of the provision of the service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(C) Example 3: Advertising services—(1) Facts. The facts are the same as in paragraph (e)(5)(ii)(A)(1) of this section (the facts in Example 1), except that DC provides an advertising service to R. DC displays advertisements for R’s restaurant chain on its social media website and smartphone application. Based on the IP addresses of the devices on which the advertisements are viewed, 20 percent of the views of the advertisements were from devices located outside the United States.

(2) Analysis. Because the service that DC provides is an advertising service, under paragraph (e)(2)(i) of this section, the amount of the provision of the advertising service is treated as the provision of a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the advertising service is included in DC’s gross FDDEI for the taxable year.

(B) Example 2: Determination of business operations that benefit from the service: alternative facts—(1) Facts. The facts are the same as in paragraph (e)(5)(ii)(A)(1) of this section (the facts in Example 1), except that DC provides an information technology service to R that benefits R’s entire business. DC determines that the use of sales is a reasonable method. R’s business operations located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $45x ($150x x 0.30) of DC’s gross income from the provision of the information technology service is included in DC’s gross FDDEI for the taxable year.

(A) Example 1: Consulting services—(1) Facts. DC provides an information technology service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the information technology service is included in DC’s gross FDDEI for the taxable year.

the United States, in exchange for $150x. Fifty percent of the sales earned by R and its related parties are from customers located outside of the United States. However, the consulting service that DC provides relates specifically to a single chain of fast food restaurants. Sales information that R provides to DC indicates that 70 percent of the sales of the fast food restaurant chain are from locations within the United States and 30 percent of the sales are from Country X. DC determines that the use of sales is a reasonable method. Therefore, 30 percent of the provision of the consulting service is treated as the provision of a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

Because using sales is a reasonable method. Therefore, 30 percent of the provision of the consulting service is treated as the provision of a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the consulting service is included in DC’s gross FDDEI for the taxable year.

The principles of § 1.482–9(k) apply to the use of sales as a reasonable method under the principles of § 1.482–9(k) to allocate the benefit of the consulting service among R’s fast food operations.

(2) Analysis. Under paragraph (e)(1) of this section, DC’s service is provided to a person located outside the United States to the extent that DC’s service confers a benefit to R’s operations outside the United States. Under paragraph (e)(2)(i) of this section, DC’s service is provided to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the consulting service is included in DC’s gross FDDEI for the taxable year.

The principles of § 1.482–9(k) apply to the use of sales as a reasonable method under the principles of § 1.482–9(k) to allocate the benefit of the consulting service among R’s fast food operations.

(2) Analysis. Under paragraph (e)(1) of this section, DC’s service is provided to a person located outside the United States to the extent that DC’s service confers a benefit to R’s operations outside the United States. Under paragraph (e)(2)(i) of this section, DC’s service is provided to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the consulting service is included in DC’s gross FDDEI for the taxable year.

The principles of § 1.482–9(k) apply to the use of sales as a reasonable method under the principles of § 1.482–9(k) to allocate the benefit of the consulting service among R’s fast food operations.

(2) Analysis. Under paragraph (e)(1) of this section, DC’s service is provided to a person located outside the United States to the extent that DC’s service confers a benefit to R’s operations outside the United States. Under paragraph (e)(2)(i) of this section, DC’s service is provided to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $30x ($150x x 0.20) of DC’s gross income from the provision of the consulting service is included in DC’s gross FDDEI for the taxable year.
(f) Proximate services. A proximate service is provided to a recipient located outside the United States if the proximate service is performed outside the United States. In the case of a proximate service performed partly within the United States and partly outside of the United States, a proportionate amount of the service is treated as provided to a recipient located outside the United States corresponding to the portion of time the renderer spends providing the service outside of the United States.

(g) Property services.—(1) In general. Except as provided in paragraph (g)(2) of this section, a property service is provided with respect to tangible property located outside the United States only if the property is located outside the United States for the duration of the period the service is performed.

(2) Exception for services provided with respect to property temporarily in the United States. A property service is deemed to be provided with respect to tangible property located outside the United States if the following conditions are satisfied—

(i) The property is temporarily in the United States for the purpose of receiving the property service;

(ii) After the completion of the service, the property will be primarily hungared, stored, or used outside the United States;

(iii) The property is not used to generate revenue in the United States at any point during the duration of the service;

(iv) The property is owned by a foreign person that resides or primarily operates outside the United States.

(h) Transportation services. Except as provided in this paragraph (h), a transportation service is provided to a recipient, or with respect to property, located outside the United States only if both the origin or the destination of the service are outside of the United States. However, in the case of a transportation service provided to a recipient, or with respect to property, where either the origin or the destination of the service is outside of the United States, but not both, then 50 percent of the gross income from the transportation service is considered derived from services provided to a recipient, or with respect to property, located outside the United States.

§ 1.250(b)–6 Related party transactions.

(a) Scope. This section provides rules for determining whether a sale of property or provision of a service to a related party is a FDDEI transaction. Paragraph (b) of this section provides definitions relevant for determining whether a sale of property or a provision of a service to a related party is a FDDEI transaction. Paragraph (c) of this section provides rules for determining whether a sale of general property to a foreign related party is a FDDEI sale. Paragraph (d) of this section provides rules for determining whether the provision of a general service to a business recipient that is a related party is a FDDEI service.

(b) Definitions. This paragraph (b) provides definitions that apply for purposes of this section.

(1) Related party sale. The term related party sale means a sale of general property to a foreign related party. See § 1.250(b)–1(e)(3)(ii)(D) (Example 4) for an illustration of a related party sale in the case of a seller that is a partnership.

(2) Related party service. The term related party service means a provision of a general service to a business recipient that is a related party of the renderer and that is described in § 1.250(b)–5(b)(2) without regard to paragraph (d) of this section.

(3) Unrelated party transaction. The term unrelated party transaction means, with respect to property purchased by a foreign related party (the "purchased property") in a related party sale from a seller—

(i) A sale of the purchased property by the foreign related party in the ordinary course of its business to a foreign unrelated party with respect to the seller;

(ii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property is a constituent part of the property sold to the foreign unrelated party;

(iii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property was sold to the foreign unrelated party that is contractually bound to only sell the product to foreign unrelated parties, past practices of the foreign related party (such as practices to only sell products to foreign unrelated parties), showing that the product sold is designed specifically for a foreign market, or books and records otherwise evidencing that sales will be made to foreign unrelated parties;

(iv) Use of property in an unrelated party transaction. A related party sale is a FDDEI sale if one or more unrelated party transactions with foreign unrelated parties would be described in § 1.250(b)–4(b) or § 1.250(b)–5(b) (definition of FDDEI service). If the property purchased in the related party sale would be used in unrelated party transactions described in the preceding sentence and other transactions, the amount of gross income from the related party sale that is attributable to a FDDEI sale is equal to the gross income from the related party sale multiplied by a fraction, the numerator of which is the revenue that the related party reasonably expects (as of the FDII filing date) to earn from all unrelated party transactions with respect to the property purchased in the related party sale that would be described in § 1.250(b)–4(b) or § 1.250(b)–5(b) and the denominator of which is the total revenue that the related party reasonably expects (as of the FDII filing date) to earn from all transactions with respect to the property purchased in the related party sale.
treated as a seller or renderer, as applicable, and the foreign unrelated party is treated as the recipient.

(3) Transactions between related parties. For purposes of determining whether an unrelated party sale has occurred and satisfies the requirements of paragraphs (c)(1) or (2) of this section with respect to a sale to a foreign related party (and not for purposes of determining whether a sale is to a foreign person as required by § 1.250(b)–4(b), all related parties of the seller are treated as if they are part of a single foreign related party. For purposes of the preceding sentence, in determining whether a United States person is a member of the seller’s modified affiliated group, and therefore a related party of the seller, the definition of the term modified affiliated group in § 1.250(b)–1(c)(17) applies without the substitution of “more than 50 percent” for “at least 80 percent” each place it appears. Accordingly, if a foreign related party sells or uses property purchased in a related party sale in a transaction with a second related party of the seller, transactions between the second related party and an unrelated party may be treated as an unrelated party transaction for purposes of applying paragraph (c)(1) of this section to a related party sale.

(4) Example. The following example illustrates the application of this paragraph (c).

(i) Facts. DC, a domestic corporation, sells a machine to FC, a foreign related party of DC in a transaction described in § 1.250(b)–4(b) (without regard to this paragraph (c)). FC uses the machine solely to manufacture product A. As of the FDII filing date for the taxable year, 75 percent of future revenue from sales by FC to unrelated parties of product A will be from sales that would be described in § 1.250(b)–4(b).

(ii) Analysis. The sale by DC to FC is a related party sale. Because FC uses the machine to make product A, but the machine is not a constituent part of product A because FC does not undertake further manufacturing with respect to the machine itself, FC’s sale of product A is an unrelated party transaction described in paragraph (b)(3)(iii) of this section. Therefore, DC’s sale of the machine is only a FDDEI sale if the requirements of paragraph (c)(1)(ii) of this section are satisfied. Because 75 percent of the revenue from future sales of product A will be from unrelated party transactions that would be described in § 1.250(b)–4(b), 75 percent of the revenues from DC’s sale of the machine to FC constitute FDDEI sales.

(d) Related party services—(1) In general. Except as provided in this paragraph (d)(1), a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been provided or will be provided by the related party to a person located within the United States. However, if a related party service is substantially similar to a service provided (in whole or in part) by the related party to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the amount of gross income from the related party service attributable to a FDDEI service is equal to the difference between the gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service. Section 250(b)(5)(C)(ii) and this paragraph (d)(1) apply only to a general service provided to a related party that is a business recipient and are not applicable with respect to any other service provided to a related party.

(ii) Rules for allocating the benefits provided by and price paid to the render of a related party service. For purposes of applying paragraph (d)(2)(ii) of this section with respect to benefits that are directly used by the related party to confer benefits on its recipients, the benefits provided by the related party to the related party are allocated to the related party’s consumers or business recipients within the United States based on the proportion of benefits conferred by the related party on consumers or business recipients located within the United States. For purposes of determining the amount of the price paid by persons located within the United States that is attributable to the related party service in applying paragraph (d)(2)(ii) of this section, if the related party provides services that confer benefits on persons located within the United States and outside the United States, the price paid for the related party service by the related party to the renderer is allocated proportionally based on the benefits conferred on each location by the related party to its recipients.

(4) Examples. The following examples illustrate the application of this paragraph (d).

(i) Assumed facts. The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.

(B) FC is a foreign corporation and a foreign related party of DC that operates solely outside the United States.

(C) The service DC provides to FC is a general service provided to a business recipient located outside the United States as described in § 1.250(b)–5(b)(2) without regard to the application of paragraph (d) of this section.

(D) The benefits conferred by DC’s service to FC’s customers are not indirect or remote within the meaning of § 1.482–9(l)(3)(i).

(ii) Examples—

(A) Example 1: Services that are substantially similar services under paragraph (d)(2)(ii) of this section—(1) Facts. FC enters into a services agreement with R, a company that operates restaurant chains within and outside the United States. Under the agreement, FC agrees to furnish a design service to R. Accordingly, if the related party serves a service to a business recipient, the related party is treated as conferring benefits on a person located within the United States to the extent that the service confers a benefit on the business recipient’s operations located within the United States. Similarly, for purposes of applying paragraph (d)(2)(ii) of this section with respect to business recipients, the price paid by a business recipient for the related party service is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party.

(B) Example 2: Service substantially similar to FDDEI service—(1) Facts. DC is a domestic corporation and provides services to FC, a foreign related party of DC. DC provides architectural services to FC. FC will use the architectural service in the provision of its design service to R. If the architectural service that DC provides to FC will serve no other purpose than to enable FC to provide its service to R, the service that FC provides will benefit only R’s operations within the United States. FC pays an arm’s length price of $300 to DC for the
architectural service and DC recognizes $50x of gross income from the service. FC incurs additional costs to add additional design elements to the plans and charges R a total of $100x for its service.

(2) Analysis. All of the service that DC provides to FC is directly used in the provision of a service to R because FC uses DC’s architectural service to provide its design service to R, and the architectural service that DC provides to FC will serve no purpose other than to enable FC to provide its service to R. In addition, FC is treated as conferring benefits only to persons located within the United States under paragraph (d)(3)(i) of this section because only R’s operations within the United States benefit from the service provided by FC. Therefore, the service provided by DC to FC is substantially similar to the service provided by FC to R under paragraph (d)(2)(i) of this section. Accordingly, DC’s provision of the architectural service to FC is not a FDDEI service under paragraph (d)(1) of this section, and DC’s gross income from the architectural service ($50x) is not included in its gross FDDEI.

(B) Example 2: Services that are not substantially similar services under paragraph (d)(2)(i) of this section—(1) Facts. The facts are the same as paragraph (d)(4)(ii)(A)(1) of this section (the facts in Example 1), except that 90 percent of R’s operations that will benefit from FC’s service are located outside the United States. Further, because FC’s service confers a benefit on R’s operations located within and outside the United States, the benefit provided by DC to FC is not substantially similar to the architectural service provided by DC under paragraph (d)(3)(ii) of this section. Therefore, only 10 percent of DC’s architectural service are directly used by FC to confer benefits on persons located within the United States under paragraph (d)(3)(ii) of this section. Therefore, the architectural service provided by DC to FC is not substantially similar to the design service provided by DC to persons located within the United States under paragraph (d)(2)(i) of this section.

(C) Example 3: Services that are substantially similar services under paragraph (d)(2)(i) of this section—(1) Facts. The facts are the same as paragraph (d)(4)(ii)(B)(1) of this section (the facts in Example 2), except that FC pays an arm’s length price of $75x to DC for the architectural service and DC recognizes $75x of gross income from the service. As in paragraph (d)(4)(ii)(A)(1) and (d)(4)(ii)(B)(1) of this section (the facts in Example 1 and Example 2), FC charges R a total of $100x for its service.

(2) Analysis—(1) Price paid by persons located within the United States. Under paragraph (d)(3)(i) of this section, FC is treated as conferring benefits on a person located within the United States to the extent that R’s operations that will benefit from FC’s service are located within the United States. Further, because FC’s service confers a benefit on R’s operations located within and outside the United States, the price paid by R to FC ($100x) is allocated proportionately based on the locations of R that benefit from the services provided by FC under paragraph (d)(3)(i) of this section. Accordingly, because 10 percent of R’s operations that will benefit from FC’s services are located within the United States, persons located within the United States are treated as paying $10x ($100x x 0.10) for FC’s services for purposes of applying the test in paragraph (d)(2)(ii) of this section.

(ii) Amount attributable to the related party service. The service that FC provides to R is attributable in part to DC’s service because FC uses the architectural plans that DC provides to provide a service to R. Under paragraph (d)(3)(ii) of this section, because the benefits of the service provided by FC are conferred on persons located within the United States and outside the United States, a proportionate amount (10 percent) of the price paid to DC for the related party service ($75x), or $7.5x, is treated as attributable to the services provided to persons located within the United States.

(iii) Application of test in paragraph (d)(2)(ii) of this section. For purposes of applying the test described in paragraph (d)(2)(ii) of this section, the price paid by persons located within the United States for the service provided by the related party (FC) is $10x, as determined in paragraph (d)(4)(ii)(C)(2)(i) of this section (the analysis of this Example 3). The amount of the price that is attributable to DC’s service is $7.5x, as determined in paragraph (d)(4)(ii)(C)(2)(i) of this section (the analysis of this Example 3). Accordingly, of the price treated as paid to FC by persons located within the United States, 75 percent ($7.5x/$10x) is attributable to the related party service. Because more than 60 percent of the price treated as paid by persons within the United States for FC’s service is attributable to DC’s service, the service provided by DC to FC is substantially similar to the design service provided by FC to persons located within the United States under paragraph (d)(2)(ii) of this section.

(iv) Conclusion. Under paragraph (d)(1) of this section, because the related party service provided by DC is substantially similar to the service provided by FC to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the difference between DC’s gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service is treated as a FDDEI service. Accordingly, $67.5x ($75x—$7.5x) of DC’s gross income from the provision of the service to FC is treated as a FDDEI service.

Par. 3. Section 1.861–8 is amended by revising the last sentence of paragraph (d)(2)(ii)(C)(1) and adding paragraph (f)(1)(vi)(N) as follows:

§ 1.861–8 Computation of taxable income from sources within the United States and from other sources and activities.

* * * * *

(d) * * * *(2) * * * *(ii) * * * *(C) * * * *(I) * * * * The term gross foreign-derived deduction eligible income, or gross FDDEI, has the meaning provided in § 1.250(b)(1)–1(c)(16).

* * * * *

(f) * * * *(1) * * * *(vi) * * * *(N) Deduction eligible income and foreign-derived deduction eligible income under section 250(b).

* * * * *

Par. 4. Section 1.962–1 is amended by:

1. Revising paragraph (a)(2).


3. Removing and reserving paragraph (b)(1)(ii).

4. Revising paragraphs (b)(2)(i) through (iii), (c), and (d)

The revisions and additions read as follows:

§ 1.962–1 Limitation of tax for individuals on amounts included in gross income under section 951(a).

(a) * * *

(2) For purposes of applying sections 960(a) and 960(d) (relating to foreign tax credit) such amounts shall be treated as if received by a domestic corporation (as provided in paragraph (b)(2) of this section).

* * * * *

(b) * * *

(1) * * *

(i) * * *

(A) * * *

(2) His GILTI inclusion amount (as defined in § 1.951A–1(c)(1)) for the taxable year; plus

* * * * *

(B) * * *

(3) The portion of the deduction under section 250 and § 1.250(a)–1 that would be allowed to a domestic corporation equal to the percentage applicable to global intangible low-taxed income for the taxable year under section 250(a)(1)(B) (including as modified by section 250(a)(3)(B)) multiplied by the sum of the amount described in paragraph (b)(1)(i)(A)(2) of this section and such amount described in paragraph (b)(1)(i)(A)(3) of this section that is attributable to the amount described in paragraph (b)(1)(i)(A)(2) of this section.

* * * * *
(ii) Application of sections 960(a) and
960(d). In applying sections 960(a) and 960(d) for purposes of this paragraph (b)(2), the shareholders of the CFC, and the U.S. dollar as their functional currency. A owns 100 percent of CFC, and includes all of its subpart F income. Therefore, all of the $400,000 of foreign income taxes that are allocable to CFC’s subpart F income are properly attributable to the section 951(a) inclusion of A, and A is deemed to pay these taxes.

(iv) Section 960(d) provides that a domestic corporation that has an inclusion in income under section 951A is deemed to pay an amount of foreign income taxes equal to 80 percent of the product of the domestic corporation’s inclusion percentage multiplied by the sum of all tested foreign income taxes. Tested foreign income taxes are the foreign income taxes of a controlled foreign corporation that are properly attributable to its tested income. Tested foreign income taxes allocated and apportioned to a domestic corporation are the domestic corporation’s proportionate share of the controlled foreign corporation’s foreign income taxes that are allocated and apportioned to the relevant tested income. See § 1.960–1–(c) and § 1.960–2(c). Because A owns 100% of CFC and takes all $3,000,000 of CFC’s tested income into account in computing A’s GILTI inclusion amount, all $600,000 of the foreign income taxes that are allocated and apportioned to the general category tested income group of CFC are tested foreign income taxes. A has an inclusion percentage of 100 percent because A’s GILTI inclusion amount equals all of A’s share of the tested income of CFC. A is therefore deemed to pay under section 960(d) 80 percent of the $600,000 of tested foreign income taxes of CFC, or $480,000 of the tested foreign income taxes.

(v) Section 962–10. § 1.962–10(a)(1) provides that, for purposes of computing taxable income under section 962, gross income includes amounts that would be included under section 78 if the shareholder with the section 951(a) inclusions were a domestic corporation. Section 78 requires a domestic corporation to include in its gross income the foreign income taxes that it is deemed to pay under section 960, computed without regard to the 80 percent limitation under section 960(d), and to which the benefits of section 901 apply. See section 78. A therefore includes in gross income the $600,000 of foreign income taxes that A is deemed to pay under section 960(d), computed without regard to the 80 percent limitation, and the $400,000 of taxes that A is deemed to pay under section 960(a).

(vi) Section 1.962–1(b)(1)(B)(3) provides that, for purposes of computing taxable income under section 962, gross income is reduced only by specified deductions, which include the deduction allowed to a domestic corporation under section 250 and § 1.250(a)(1) equal to 50 percent of the sum of the GILTI inclusion amount and the

* * * * * *

(c) Example. The application of this section may be illustrated by the following example.

(1) Facts—(i) Individual A is a U.S. resident who owns all of the shares of the one class of stock in CFC, a controlled foreign corporation. A and CFC each use the calendar year as their U.S. and foreign taxable years and the U.S. dollar as their functional currency. A owns no direct or indirect interest in any other controlled foreign corporation.

(ii) For the 2019 taxable year, CFC has $6,000,000 of pre-tax foreign earnings with respect to which it accrues and pays $1,000,000 of foreign income tax, leaving $5,000,000 of after-tax net income. Of this amount, $3,000,000 is general category tested income as defined in section 951A(c)(2), and $2,000,000 is passive category subpart F income described in sections 952 and 904(d)(1)(C) that is all in a single subpart F income group under §§ 1.954–1(c)(1)(iii) and 1.960–1(c)(2)(ii)(D). Of the $3,000,000 of foreign income taxes paid or accrued by CFC, $600,000 is allocated and apportioned to its general category tested income group and $400,000 is allocated and apportioned to its passive category subpart F income group under § 1.960–1–(c)(1). (iii) For the 2019 taxable year, A includes under section 951A(a) all $3,000,000 of the tested income of CFC as A’s GILTI inclusion amount, as defined in § 1.951A–1(c)(1). In addition, A includes under section 951(a)(1) the $2,000,000 of passive category subpart F income of CFC.

(iv) For the 2019 taxable year, A earns $1,000,000 of foreign source passive category gross income and $3,000,000 of U.S. source gross income. A pays $1,000,000 of foreign withholding taxes with respect to the $1,000,000 of foreign source passive category gross income. A incurs $1,000,000 of deductible expenses for the 2019 taxable year that are definitely related to all of A’s gross income and are properly allocated and apportioned under §§ 1.861–8(b)(5) and 1.861–8T(c)(1) among the section 904 statutory and residual groupings on the basis of the relative amounts of gross income in each grouping.

(v) A elects to apply section 962 and chooses to claim credits under section 901 for the 2019 taxable year.

(2) Analysis with respect to section 962 taxable income—(i) Section 962(a)(1) and § 1.962–1(a)(1) provide that when an individual United States shareholder elects to apply section 962 for a taxable year, the U.S. tax imposed with respect to amounts that the individual includes under section 951(a) (the “section 951(a) inclusions”) equals the tax that would be imposed under section 11 if the amounts were included by a domestic corporation under section 951(a). For purposes of section 962, A includes under section 951A an amount, as defined in § 1.951A–1(c)(1). In addition, A includes under section 951(a)(1) the $2,000,000 of passive category subpart F income of CFC.

(ii) Section 962(a)(2), § 1.962–1(b)(1)(i) and § 1.962–1(b)(1)(ii) provide that sections 960(a) and 962 apply to the section 951(a) inclusions of an electing individual United States shareholder as though the inclusions were received by a domestic corporation, and the electing individual United States shareholder is allowed a credit against the U.S. tax imposed with respect to the section 951(a) inclusions.

(iii) Section 962(a)(3) deems a domestic corporation that is a United States shareholder of a controlled foreign corporation to pay the foreign income taxes paid or accrued by the foreign corporation that are properly attributable to the foreign corporation’s items of income included in the domestic corporation’s income under section 951(a). The foreign income taxes of a CFC that are properly attributable to such items are the domestic corporation’s proportionate share of the taxes that are allocated and apportioned to the relevant subpart F income group. See § 1.960–1(c) and § 1.960–2(b). A owns 100 percent of CFC, and includes all of its subpart F income. Therefore, all of the $400,000 of foreign income taxes that are allocable to CFC’s subpart F income are properly attributable to the section 951(a) inclusion of A, and A is deemed to pay these taxes.

(iv) Section 960(d) provides that a domestic corporation that has an inclusion in income under section 951A is deemed to pay an amount of foreign income taxes equal to 80 percent of the product of the domestic corporation’s inclusion percentage multiplied by the sum of all tested foreign income taxes. Tested foreign income taxes are the foreign income taxes of a controlled foreign corporation that are properly attributable to its tested income. Tested foreign income taxes are the foreign income taxes of a CFC that are properly attributable to its tested income. Tested foreign income taxes are the foreign income taxes of a controlled foreign corporation that are properly attributable to its tested income.

(v) Section 1.962–10(a)(1) provides that, for purposes of computing taxable income under section 962, gross income includes amounts that would be included under section 78 if the shareholder with the section 951(a) inclusions were a domestic corporation. Section 78 requires a domestic corporation to include in its gross income the foreign income taxes that it is deemed to pay under section 960, computed without regard to the 80 percent limitation under section 960(d), and to which the benefits of section 901 apply. See section 78. A therefore includes in gross income the $600,000 of foreign income taxes that A is deemed to pay under section 960(d), computed without regard to the 80 percent limitation, and the $400,000 of taxes that A is deemed to pay under section 960(a).

(vi) Section 1.962–1(b)(1)(B)(3) provides that, for purposes of computing taxable income under section 962, gross income is reduced only by specified deductions, which include the deduction allowed to a domestic corporation under section 250 and § 1.250(a)(1) equal to 50 percent of the sum of the GILTI inclusion amount and the

* * * * * *
(viii) Section 962 and §1.962–1(b)(2) provide that, in computing the section 904 limitation on the credit for foreign income taxes that an electing individual United States shareholder is deemed to pay under sections 960(a) and (d), the individual’s taxable income for a taxable year is considered to consist only of section 951(a) inclusions and the deductions allowed under section 962. Section 904 limits the credit that a taxpayer may claim for the taxes that it pays or accrues, or is deemed to pay, to the amount of its U.S. tax that is attributable to the taxpayer’s foreign source income, and applies this limitation separately with respect to each separate category of income. The limitation amount is computed by multiplying the taxpayer’s total pre-credit U.S. tax by the ratio of the taxpayer’s foreign source taxable income in a separate category for the taxable year to the taxpayer’s total taxable income for the taxable year. See section 904(a) and §1.904–1(a).

(x) A also must compute the limitation on the credit for the foreign income taxes deemed paid under section 960(a) separately with respect to the foreign source passive category income under section 962, namely, A’s taxable income attributable to the subpart F inclusion. A computes the limitation by multiplying A’s pre-credit U.S. tax of $882,000 by the ratio of A’s foreign source passive category taxable income under section 962 to A’s total taxable income under section 962, as follows:

(xii) A may claim a foreign tax credit for $378,000 of the $480,000 of foreign income taxes deemed paid under section 960(d), and a foreign tax credit for all $400,000 of the foreign income taxes deemed paid under section 960(a), for a total foreign tax credit of $778,000. The U.S. tax on A’s 2019 taxable income with respect to CFC under section 962 is reduced from $882,000 to $104,000 ($882,000 minus $778,000).

(iii) Analysis with respect to other income—

(ii) A must compute a separate limitation on the credit for the foreign withholding taxes paid with respect to A’s other foreign source passive category taxable income. Under §1.962–1(b)(2)(vii)(B), A’s section 904 limitation on this income is computed on the basis of A’s taxable income other than the amounts taken into account under §1.962–1(b)(1)(i). Accordingly, $250,000 of A’s deductions ($1,000,000 × $1,000,000/$4,000,000) are apportioned to A’s $1,000,000 of other foreign source passive category gross income, and $750,000 of deductions ($1,000,000 × $3,000,000/$4,000,000) are apportioned to A’s $3,000,000 of U.S. source gross income, resulting in $750,000 of other foreign source passive category taxable income and $2,250,000 of U.S. source taxable income. A computes the limitation by multiplying A’s pre-credit U.S. tax on A’s other income of

\[
\text{TABLE 1 TO PARAGRAPH (c)(2)(vii)}
\]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 951(a) inclusions with respect to CFC</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Section 78 inclusions</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Deduction under section 250</td>
<td>($1,800,000)</td>
</tr>
<tr>
<td>Taxable income under section 962</td>
<td>$4,200,000</td>
</tr>
<tr>
<td>Pre-credit U.S. tax (0.21 × $4,200,000)</td>
<td>$882,000</td>
</tr>
</tbody>
</table>

\[
\text{TABLE 2 TO PARAGRAPH (c)(2)(ix)}
\]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>GILTI inclusion amount</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Section 78 inclusion</td>
<td>$600,000</td>
</tr>
<tr>
<td>Section 250 deduction</td>
<td>($1,800,000)</td>
</tr>
<tr>
<td>Total GILTI category taxable income under section 962</td>
<td>$1,800,000</td>
</tr>
<tr>
<td>Ratio of GILTI category taxable income to total taxable income under section 962</td>
<td>$42.86%</td>
</tr>
<tr>
<td>Limitation amount (pre-credit U.S. tax of $882,000 × ($1,800,000/$4,200,000))</td>
<td>$378,000</td>
</tr>
</tbody>
</table>

\[
\text{TABLE 3 TO PARAGRAPH (c)(2)(x)}
\]

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subpart F Inclusion</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Section 78 inclusion</td>
<td>$400,000</td>
</tr>
<tr>
<td>Total foreign source passive category taxable income</td>
<td>$2,400,000</td>
</tr>
<tr>
<td>Ratio of foreign source passive category taxable income to total taxable income under section 962</td>
<td>57.14%</td>
</tr>
<tr>
<td>Limitation amount (pre-credit U.S. tax of $882,000 × ($2,400,000/$4,200,000))</td>
<td>$504,000</td>
</tr>
</tbody>
</table>
(iii) A may claim a foreign tax credit under section 901 for all $100,000 of the foreign withholding taxes on the other passive income. The U.S. tax on A's $3,000,000 of other taxable income is reduced from $1,074,988 to $974,988 ($1,074.88 minus $100,000).

(d) Applicability dates. Except as otherwise provided in this paragraph (d), paragraph (b)(1)(i) of this section applies beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Paragraphs (b)(1)(i)(A)(2) and (b)(1)(i)(B)(3) of this section apply to taxable years of a foreign corporation that end on or after March 4, 2019, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. Paragraphs (a)(2), (b)(1)(ii), (b)(2)(i) through (iii), and (c) of this section apply to taxable years of a foreign corporation that end on or after July 15, 2020, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends. For taxable years that precede the taxable year of the foreign corporation, paragraphs (a)(2), (b)(1)(ii), (b)(2)(i) through (iii), and (c) of this section apply to taxable years of a foreign corporation beginning on or after January 1, 2018, and with respect to a United States person, for the taxable year in which or with which such taxable year of the foreign corporation ends.

Par. 5. Section 1.1502–12 is amended by adding paragraph (t) to read as follows:

§ 1.1502–12 Separate taxable income.
* * * * *
(t) See § 1.1502–50 for rules relating to the computation of a member’s deduction under section 250.
* * * * *

Par. 6. Section 1.1502–13 is amended by:

1. In paragraph (a)(6)(ii), under the heading “Matching rule. (§ 1.1502–13(c)(7)(ii))”, designating Examples 1 through 17 as entries (A) through (Q).

2. In paragraph (a)(6)(ii) under the heading “Matching rule. (§ 1.1502–13(c)(7)(ii))”, adding entry (R).

3. In paragraph (c)(7)(ii), Examples 1 through 17 are designated as paragraphs (c)(7)(ii)(A) through (Q), respectively.

4. Redesignating newly designated paragraphs (c)(7)(ii)(A)(a) through (i) as paragraphs (c)(7)(ii)(A)(1) through (9). paragraphs (c)(7)(ii)(B)(a) and (b) as paragraphs (c)(7)(ii)(B)(1) and (2).

5. Redesignating newly designated paragraphs (c)(7)(ii)(B)(a) and (b) as paragraphs (c)(7)(ii)(B)(1) and (2).

6. Redesignating newly designated paragraphs (c)(7)(ii)(C)(a) through (d) as paragraphs (c)(7)(ii)(C)(1) through (4). paragraphs (c)(7)(ii)(D)(a) through (e) as paragraphs (c)(7)(ii)(D)(1) through (5). paragraphs (c)(7)(ii)(E)(a) through (f) as paragraphs (c)(7)(ii)(E)(1) through (6).

7. Redesignating newly designated paragraphs (c)(7)(ii)(E)(a) through (f) as paragraphs (c)(7)(ii)(E)(1) through (6).

8. Redesignating newly designated paragraphs (c)(7)(ii)(F)(a) through (d) as paragraphs (c)(7)(ii)(F)(1) through (4).

9. Redesignating newly designated paragraphs (c)(7)(ii)(F)(a) through (d) as paragraphs (c)(7)(ii)(F)(1) through (4).

10. Redesignating newly designated paragraphs (c)(7)(ii)(G)(a) through (e) as paragraphs (c)(7)(ii)(G)(1) through (5).

11. Redesignating newly designated paragraphs (c)(7)(ii)(H)(a) through (d) as paragraphs (c)(7)(ii)(H)(1) through (4).

12. Redesignating newly designated paragraphs (c)(7)(ii)(I)(a) through (d) as paragraphs (c)(7)(ii)(I)(1) through (4).

13. Redesignating newly designated paragraphs (c)(7)(ii)(J)(a) through (d) as paragraphs (c)(7)(ii)(J)(1) through (4).

14. Redesignating newly designated paragraphs (c)(7)(ii)(K)(a) through (d) as paragraphs (c)(7)(ii)(K)(1) through (4).

15. Redesignating newly designated paragraphs (c)(7)(ii)(L)(a) through (e) as paragraphs (c)(7)(ii)(L)(1) through (5).

16. Redesignating newly designated paragraphs (c)(7)(ii)(M)(a) through (d) as paragraphs (c)(7)(ii)(M)(1) through (4).

17. Redesignating newly designated paragraphs (c)(7)(ii)(N)(a) through (d) as paragraphs (c)(7)(ii)(N)(1) through (4).

18. Redesignating newly designated paragraphs (c)(7)(ii)(O)(a) through (e) as paragraphs (c)(7)(ii)(O)(1) through (5).

19. In the table in this paragraph, for each newly redesignated paragraph listed in the “Paragraph” column, remove the text indicated in the “Remove” column and add in its place the text indicated in the “Add” column:

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Remove</th>
<th>Add</th>
</tr>
</thead>
<tbody>
<tr>
<td>(c)(7)(ii)(A)(5)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(A)(6)</td>
<td>paragraph (a) of this Example 2</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(A)(7)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(A)(8)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(A)(9)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(A)(10)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(A)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(B)(3)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(B)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(C)(3)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(C)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(C)(4)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(C)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(D)(3)</td>
<td>paragraph (a) of this Example 1</td>
<td>Example 1 in paragraph (c)(7)(ii)(D)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(E)(3)</td>
<td>paragraph (a) of this Example 5</td>
<td>Example 5 in paragraph (c)(7)(ii)(E)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(E)(4)</td>
<td>paragraph (a) of this Example 5</td>
<td>Example 5 in paragraph (c)(7)(ii)(E)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(E)(5)</td>
<td>paragraph (a) of this Example 5</td>
<td>Example 5 in paragraph (c)(7)(ii)(E)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(E)(6)</td>
<td>paragraph (a) of this Example 5</td>
<td>Example 5 in paragraph (c)(7)(ii)(E)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(F)(3)</td>
<td>paragraph (a) of this Example 6</td>
<td>Example 6 in paragraph (c)(7)(ii)(F)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(F)(4)</td>
<td>paragraph (a) of this Example 6</td>
<td>Example 6 in paragraph (c)(7)(ii)(F)(1) of this section.</td>
</tr>
<tr>
<td>(c)(7)(ii)(G)(4)</td>
<td>paragraph (a) of this Example 7</td>
<td>Example 7 in paragraph (c)(7)(ii)(G)(1) of this section.</td>
</tr>
</tbody>
</table>
§ 1.1502–13 Intercompany transactions.

(a) * * *

(i) * * *

Matching rule. (§ 1.1502–13(c)(7)(iii))

* * * * *

(R) Example 18. Redetermination of attributes for section 250 purposes.

* * * * *

(c) * * *

(7) * * *

(ii) * * *

(R) Example 19: Redetermination of attributes for section 250 purposes—(1) Facts. S manufactures equipment in the United States and recognizes $75 of gross income included in gross DEI that is included in gross FDDEI that is included in gross DEI that is included in gross FDDEI (as defined in § 1.250(b)(1)(14)) and B would have $25 of gross income included in gross FDDEI, of which only $25 is included in gross FDDEI. Thus, on a separate entity basis, S and B would have, in the aggregate, $100 of gross income included in gross DEI, of which only $25 is included in gross FDDEI. Accordingly, under single entity treatment, $75 that would be treated as gross income included in gross DEI that is included in gross FDDEI on a separate entity basis is redetermined to be included in gross FDDEI.

(ii) Intercompany sale for loss. The facts are the same as in paragraph (c)(7)(iii)(R)(1) of this section (the facts in Example 18), except that S recognizes $25 of loss on the sale of Asset. S’s $25 of intercompany loss is taken into account under the matching rule to reflect the $25 difference between B’s $25 corresponding item taken into account (based on B’s $100 cost basis in Asset) and the recomputed corresponding item (based on the $125 basis that B would have if S and B were divisions of a single corporation and B’s basis were determined by reference to S’s basis). In determining whether S’s gross income included in gross DEI from the sale of Asset is included in gross FDDEI, S and B are treated as divisions of a single corporation. See paragraph (a)(6) of this section. In determining the amount of income included in gross DEI that is included in gross FDDEI, the attributes of S’s intercompany item and B’s corresponding item may be redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. See paragraph (c)(1)(i) of this section. Applying section 250 and § 1.1502–50 on a single entity basis, all $100 of income included in gross DEI would be gross FDDEI. On a separate entity basis, S would have $75 of gross income included in gross DEI that is included in gross FDDEI (as defined in § 1.250(b)(1)(14)) and B would have $25 of gross income included in gross FDDEI, of which only $25 is included in gross FDDEI. Thus, on a separate entity basis, S and B would have, in the aggregate, $100 of gross income included in gross DEI, of which only $25 is included in gross FDDEI. Accordingly, under single entity treatment, $75 that would be treated as gross income included in gross DEI that is included in gross FDDEI that is included in gross FDDEI is redetermined to be included in gross FDDEI.

§ 1.1502–50 Consolidated section 250.

(a) In general—(1) Scope. This section provides rules for applying section 250 and §§ 1.250–1 through 1.250(b)–6 (the section 250 regulations) to a member of a consolidated group (member). Paragraph (b) of this section provides rules for the determination of the amount of the deduction allowed to a member under section 250(a)(1).

(b) Allowance of deduction—(1) In general. A member is allowed a deduction for a consolidated return year under section 250 to members appropriately reflects the income, expenses, gains, losses, and property of all members. Paragraph (b) of this section allocates the consolidated group’s overall deduction amount under section 250 to each member on the basis of its contribution to the consolidated foreign-derived deduction eligible income (consolidated FDDEI) and consolidated global intangible low-taxed income (consolidated GILTI).

The definitions in paragraph (e) of this section provide for the aggregation of the deduction eligible income (DEI), FDDEI, deemed tangible income return, and global intangible low-taxed income (GILTI) of all members in order to calculate the consolidated group’s overall deduction amount under section 250.

Par. 7. Section 1.1502–50 is added to read as follows:

§ 1.1502–50 Consolidated section 250.

(a) In general—(1) Scope. This section provides rules for applying section 250 and §§ 1.250–1 through 1.250(b)–6 (the section 250 regulations) to a member of a consolidated group (member). Paragraph (b) of this section provides rules for the determination of the amount of the deduction allowed to a member under section 250(a)(1).
any, is recognized in the transaction and time, and to the extent, gain or loss, if includes a basis adjustment under (as defined in § 1.250(b)–2(g)(7)) to the determination of the consolidated FDII deduction amount and the consolidated GILTI deduction amount of a consolidated group for a consolidated return year—

(i) The consolidated foreign-derived intangible income (consolidated FDII) (if any) is reduced (but not below zero) by an amount which bears the same ratio to the consolidated section 250(a)(2) amount that such consolidated FDII bears to the sum of the consolidated FDII and the consolidated GILTI; and

(ii) The consolidated GILTI (if any) is reduced (but not below zero) by the excess of the consolidated section 250(a)(2) amount over the reduction described in paragraph (b)(2)(i) of this section.

c) Impact of intercompany transactions—(1) Impact on qualified business asset investment determination—(i) In general. For purposes of determining a member’s QBAI, the basis of specified tangible property does not include an amount equal to any gain or loss recognized with respect to such property by another member in an intercompany transaction (as defined in § 1.1502–13(b)(1)) until the time that such gain or loss is no longer deferred under § 1.1502–13. Thus, for example, if a selling member owns specified tangible property with an adjusted basis (within the meaning of section 1011) of $60x and an adjusted basis (for purposes of calculating QBAI) of $80x, and sells it for $50x to the purchasing member (and the intercompany loss remains deferred), the basis of such property for purposes of computing the purchasing member’s QBAI is $80x.

(ii) Partner-specific QBAI basis. A member’s partner-specific QBAI basis (as defined in § 1.250(b)–2(g)(7)) includes a basis adjustment under section 743(b) resulting from an intercompany transaction only at the time, and to the extent, gain or loss, if any, is recognized in the transaction and no longer deferred under § 1.1502–13.

d) Impact on foreign-derived deduction eligible income characterization. For purposes of redetermining attributes of members from an intercompany transaction as FDDEI, see § 1.1502–13(c)(1)(i) and (c)(7)(ii)(R) (Example 18).

d) Adjustments to the basis of a member. For adjustments to the basis of a member related to paragraph (b)(1) of this section, see § 1.1502–32(b)(3)(ii)(B).

(e) Definitions. The following definitions apply for purposes of this section.

(1) Consolidated deduction eligible income (consolidated DEI). With respect to a consolidated group for a consolidated return year, the term consolidated deduction eligible income or consolidated DEI means the greater of the sum of the DEI (whether positive or negative) of all members or zero.

(2) Consolidated deemed intangible income. With respect to a consolidated group for a consolidated return year, the term consolidated deemed intangible income means the excess (if any) of the consolidated DEI, over the consolidated deemed tangible income return.

(3) Consolidated deemed tangible income return. With respect to a consolidated group for a consolidated return year, the term consolidated deemed tangible income return means the sum of the deemed tangible income return of all members.

(4) Consolidated FDII deduction amount. With respect to a consolidated group for a consolidated return year, the term consolidated FDII deduction amount means the product of the FDII deduction rate and the consolidated FDII, as adjusted by paragraph (b)(2) of this section.

(5) Consolidated foreign-derived deduction eligible income (consolidated FDDEI). With respect to a consolidated group for a consolidated return year, the term consolidated foreign-derived deduction eligible income or consolidated FDDEI means the greater of the sum of the FDDEI (whether positive or negative) of all members or zero.

(6) Consolidated foreign-derived intangible income (consolidated FDII). With respect to a consolidated group for a consolidated return year, the term consolidated foreign-derived intangible income or consolidated FDII means the product of the consolidated deemed intangible income and the consolidated foreign-derived ratio.

(7) Consolidated foreign-derived ratio. With respect to a consolidated group for a consolidated return year, the term consolidated foreign-derived ratio means the ratio (not to exceed one) of—

(i) The consolidated FDDEI; to

(ii) The consolidated DEI.

(8) Consolidated GILTI deduction amount. With respect to a consolidated group for a consolidated return year, the term consolidated GILTI deduction amount means the product of the GILTI deduction rate and the sum of the consolidated GILTI, as adjusted by paragraph (b)(2) of this section, and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year.

(9) Consolidated global intangible low-taxed income (consolidated GILTI). With respect to a consolidated group for a consolidated return year, the term consolidated global intangible low-taxed income or consolidated GILTI means the sum of the GILTI of all members.

(10) Consolidated section 250(a)(2) amount. With respect to a consolidated group for a consolidated return year, the term consolidated section 250(a)(2) amount means the excess (if any) of the sum of the consolidated FDII and the consolidated GILTI (determined without regard to section 250(a)(2) and paragraph (b)(2) of this section), over the consolidated taxable income of the consolidated group (within the meaning of § 1.1502–11).

(11) Deduction eligible income (DEI). With respect to a member for a consolidated return year, the term deduction eligible income or DEI means the member’s gross DEI for the year (within the meaning of § 1.250(b)–1(c)(15)) reduced (including below zero) by the deductions properly allocable to gross DEI for the year (as determined under § 1.250(b)–1(d)(2)).

(12) Deemed tangible income return. With respect to a member for a consolidated return year, the term deemed tangible income return means an amount equal to 10 percent of the member’s QBAI, as adjusted by paragraph (c)(1) of this section.

(13) FDII deduction allocation ratio. With respect to a member for a consolidated return year, the term FDII deduction allocation ratio means the ratio of—

(i) The member’s positive FDDEI (if any); to

(ii) The sum of the positive FDDEI of all members.

(14) FDII deduction rate. The term FDII deduction rate means 37.5 percent for consolidated return years beginning before January 1, 2026, and 21.875 percent for consolidated return years beginning after December 31, 2025.

(15) Foreign-derived deduction eligible income (FDDEI). With respect to a member for a consolidated return year, the term foreign-derived deduction eligible income or FDDEI means the member’s gross FDDEI for the year (within the meaning of § 1.250(b)–1(c)(16)) reduced (including below zero) by the deductions properly allocable to gross FDDEI for the year (as determined under § 1.250(b)–1(d)(2)).

(16) GILTI deduction allocation ratio. With respect to a member for a consolidated return year, the term GILTI
tangible income return is $400x ($500x
× 0.10)
return is $400x ($500x × 0.10)
× $100x). Under paragraph (e)(7) of this section, the P group’s consolidated deemed intangible income return is $100x. Under paragraph (e)(8) of this section, the P group’s consolidated deemed intangible income return is $85x, the sum of the GILTI of all members ($0 + $65x + $20x) or zero.
(ii) Analysis—(A) Consolidated DEI. Under paragraph (e)(5) of this section, the P group’s consolidated DEI is $500x and the P group’s consolidated deemed tangible income return is $100x. (B) Consolidated FDDEI. Under paragraph (e)(5) of this section, the P group’s consolidated FDDEI is $200x, the greater of the sum of the FDDEI (whether positive or negative) of all members (−$100x + $200x + $100x) or zero. (C) Consolidated deemed tangible income and consolidated FDII. Under paragraph (e)(2) of this section, the P group’s consolidated deemed tangible income is $400x ($500x − $100x). Under paragraph (e)(7) of this section, the P group’s consolidated foreign-derived rate is 1.00 ($600x/$500x, but not in excess of one). Under paragraph (e)(6) of this section, the P group’s consolidated FDII is $400x ($400x × 1.00).
(D) Consolidated FDII deduction amount and member’s deduction attributable to consolidated FDII deduction amount. Under paragraph (e)(4) of this section, the P group’s consolidated FDII deduction amount is $150x (0.375 × $400x). Under paragraph (e)(13) of this section, the FDII deduction allocation ratios of F, US1, and US2 are 0.375 ($300/ $600x), 0.0 (0.0), and 0.625 (0.625) (0.625) ($100x/ $150x) and $20x (0.13) ($20x/ $150x), respectively. Therefore, P, US1, and US2 are permitted deductions under paragraph (b)(1) of this section in the amounts of $75x (0.375 × $200x), $50x (0.625 × $150x), and $20x (0.13 × $150x), respectively.
(3) Example 3: Member with negative FDDEI—(i) Facts. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in Example 1), except that F’s FDDEI is $-100x.
(ii) Analysis—(A) Consolidated DEI and consolidated deemed tangible income return. As in paragraphs (f)(1)(ii)(A) and (C) of this section (the facts in Example 1), the P group’s consolidated DEI is $500x and the P group’s consolidated deemed tangible income return is $100x.
(B) Consolidated FDDEI. Under paragraph (e)(5) of this section, the P group’s consolidated FDDEI is $200x, the greater of the sum of the FDDEI (whether positive or negative) of all members (−$100x + $200x + $100x) or zero.
(C) Consolidated deemed intangible income and consolidated FDII. Under paragraphs (e)(2) and (6) of this section, the P group’s consolidated deemed intangible income is $400x ($500x − $100x), and the P group’s consolidated FDII is $160x ($400x × ($200x/$500x)).
(D) Consolidated FDII deduction amount and member’s deduction attributable to consolidated FDII deduction amount. Under paragraph (e)(4) of this section, the P group’s consolidated FDII deduction amount is $60x (0.375 × $160x). Under paragraph (e)(13) of this section, the FDII deduction allocation ratios of P, US1, and US2 are 0.0 (0.0), 0.5 (0.5) ($200x/$300x), and 0.5 (0.5) ($100x/$300x), respectively. Therefore, P, US1, and US2 are permitted deductions under paragraph (b)(1) of this section in the amounts of $0 (0 × $60x), $40x (0.67 × $60x), and $20x (0.13 × $60x), respectively.
(4) Example 4: Calculation of deduction attributable to GILTI—(i) Facts. The facts are the same as in paragraph (f)(1)(i) of this section (the facts in Example 1), except that US1 owns CF1 and US2 owns CF2. US1 and US2 have GILTI of $65x and $20x, respectively, and amounts treated as dividends received under section 78 attributable to their GILTI of $10x and $5x, respectively.
(ii) Analysis—(A) Consolidated GILTI. Under paragraph (e)(9) of this section, the P group’s consolidated GILTI is $85x, the sum of the GILTI of all members ($0 + $65x + $20x).
(B) Consolidated GILTI deduction amount. Under paragraph (e)(8) of this section, the P group’s consolidated GILTI deduction amount is $50x, the product of the GILTI deduction rate and the sum of its consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their

(ii) The sum of consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year; to
(g) Global intangible low-taxed income (GILTI). With respect to a member for a consolidated return year, the term "global intangible low-taxed income" or "GILTI" means the sum of the member’s GILTI inclusion amount under § 1.951A–51(b) and the member’s distributive share of any domestic partnership’s GILTI inclusion amount under § 1.951A–51(c).
(h) Qualified business asset investment (QBAI). The term "qualified business asset investment" or "QBAI" means the meaning provided in § 1.1502–51(b). The term "qualified business property" means the meaning provided in § 1.1502–51(c). (i) Examples. The following examples illustrate the rules of this section.
(Example 1: Calculation of deduction attributable to FDI—(i) Facts. P is the common parent of the P group and owns all of the only class of stock of subsidiaries USS1 and USS2. The consolidated return year of all persons is the calendar year. In 2018, P has DEI of $400x, FDDEI of $0, and QBAI of $0; USS1 has DEI of $200x, FDDEI of $200x, QBAI of $600x; and USS2 has DEI of $100x, FDDEI of $100x, and QBAI of $400x. The P group has consolidated taxable income which is sufficient to make inapplicable the limitation in paragraph (b)(2) of this section. No member of the P group has GILTI.
(ii) Analysis—(A) Consolidated DEI. Under paragraph (e)(1) of this section, the P group’s consolidated DEI is $500x, the greater of the sum of the DEI (whether positive or negative) of all members ($400x + $200x − $100x) or zero.
(B) Consolidated FDDEI. Under paragraph (e)(5) of this section, the P group’s consolidated FDDEI is $300x, the greater of the sum of the FDDEI (whether positive or negative) of all members ($0 + $200x + $100x) or zero.
(C) Consolidated deemed tangible income return. Under paragraph (e)(12) of this section, a member’s deemed tangible income return is 10 percent of its QBAI. Therefore, P’s deemed tangible income return is $0 (0.10 × $0), USS1’s deemed tangible income return is $60x (0.10 × $600x), and USS2’s deemed tangible income return is $40x (0.10 × $400x).

Deduction allocation ratio means the ratio of—
(i) The sum of the member’s GILTI and the amount treated as a dividend received by the member under section 78 which is attributable to its GILTI for the consolidated return year; to (ii) The sum of consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year.

Example 1 illustrates the rules of this section.
(C) Member’s deduction attributable to consolidated GILTI deduction amount. Under paragraph (b)(1) of this section, a member is allowed a deduction equal to the product of the GILTI deduction amount of the consolidated group to which the member belongs and the member’s GILTI deduction allocation ratio. Under paragraph (e)(16) of this section, a member’s GILTI deduction allocation ratio is the ratio of the sum of its member’s GILTI deduction amount and the amounts treated as a dividend received by the member under section 78 which is attributable to its GILTI for the consolidated return year to the sum of the consolidated GILTI and the amounts treated as dividends received by the members under section 78 which are attributable to their GILTI for the consolidated return year. As a result, the GILTI deduction allocation ratios of P, USS1, and USS2 are 0 (0/$85x + $10x + $5x), ¼ ($85x + $10x)/$85x, and 1 (1/$85x + $10x + $5x), respectively. Therefore, P, USS1, and USS2 are permitted deductions of $0 (0 × $50x), $37.50x (¼ × $50x), and $12.50x (¼ × $50x), respectively.

(D) Member’s deduction under section 250. Under paragraph (b)(1) of this section, a member is allowed a deduction equal to the sum of the member’s deduction attributable to the consolidated FDII deduction amount and the member’s deduction attributable to the consolidated GILTI deduction amount. As a result, P, USS1, and USS2 are entitled to deductions under paragraph (b)(1) of this section of $12.50x, $78.46x, and $11.68x, respectively. Therefore, P, USS1, and USS2 are permitted deductions attributable to the consolidated GILTI deduction amount of $83.08x ($221.54x - $138x), $55.39x ($244x - $184x), and $27.69x ($240x - $172x), respectively.

(E) Member’s deduction attributable to the consolidated GILTI deduction amount. As in paragraph (D) of this section (the analysis in Example 1), the FDII deduction allocation ratios of P, USS1, and USS2 are 0.50, ⅔, and ¼, respectively. Therefore, P, USS1, and USS2 are permitted deductions attributable to the consolidated GILTI deduction amount of $83.08x ($221.54x - $138x), $55.39x ($244x - $184x), and $27.69x ($240x - $172x), respectively.

(F) Member’s deduction pursuant section 250. Under paragraph (b)(1) of this section, a member is allowed a deduction equal to the sum of the member’s deduction attributable to the consolidated GILTI deduction amount and the member’s deduction attributable to the consolidated GILTI deduction amount. As a result, P, USS1, and USS2 are entitled to deductions under paragraph (b)(1) of this section of $0 ($0 + $0), $0 ($0 + $0), and $0 ($0 + $0), respectively.

(g) Applicability date. This section applies to consolidated return years beginning on or after January 1, 2021. A taxpayer that chooses to apply the rules in § 1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 to taxable years beginning before January 1, 2021, pursuant to § 1.250-1(b), must also apply the rules of this section in their entirety to consolidated return years beginning after December 31, 2017, and before January 1, 2021.

§ 1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations.

(15) Information reporting under section 250. If the person required to file Form 5471 (or any successor form) claims a deduction under section 250(a) that is determined, in whole or part, by reference to its foreign-derived intangible income, and any amount required to be reported under paragraph (f)(11) of this section is included in its computation of foreign-derived deduction eligible income, such person will provide on Form 5471 (or any successor form) such information that is prescribed by the form, instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin.

Par. 9. Section 1.6038–3 is amended by adding paragraph (g)(4) and a sentence to the end of paragraph (l) to read as follows:

§ 1.6038–3 Information returns required of certain United States persons with respect to controlled foreign partnerships (CFPs).

(4) Additional information required to be submitted by a controlling ten-percent or a controlling fifty-percent partner that has a deduction under section 250 by reason of FDII. In addition to the information required pursuant to paragraphs (g)(1), (2), and (3) of this section, if, with respect to the partnership’s tax year for which Form 8865 is being filed, a controlling ten-percent partner or a controlling fifty-percent partner has a deduction under section 250 by reason of having foreign-derived intangible income, determined, in whole or in part, by reference to the income, assets, or activities of the partnership, or transactions between the controlling-ten percent partner or controlling fifty-percent partner and the partnership, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership’s gross DEI, gross FDDIE, deductions that are properly allocable to the partnership’s gross DEI and gross FDDIE, and partnership QBAI (as those terms are defined in the section 250 regulations) in the form and manner and to the extent prescribed by Form 8865 (or any successor form), instructions to
the form, publication, or other guidance published in the Internal Revenue Bulletin. To the extent that the partnership amounts described in the previous sentence cannot be determined, the controlling ten-percent partner or controlling fifty-percent partner must provide its share of the partnership’s attributes that the partner uses to determine the partner’s gross DEI, gross FDDEI, deductions that are properly allocable to the partner’s gross DEI and gross FDDEI, and the partner’s adjusted bases in partnership specified tangible property.

* * * * *

(l) * * * Paragraph (g)(4) of this section applies for tax years of a foreign partnership beginning on or after March 4, 2019.

Par. 10. Section 1.6038A–2 is amended by adding paragraph (b)(5)(iv) and a sentence at the end of paragraph (g) to read as follows:

§ 1.6038A–2 Requirement of return.

* * * * *

(b) * * *

(5) * * *

(iv) If, for the taxable year, the reporting corporation has a deduction under section 250 (by reason of having foreign-derived intangible income) with respect to any amount required to be reported under paragraph (b)(3) or (4) of this section, the reporting corporation will provide on Form 5472 (or any successor form) such information about the deduction in the form and manner and to the extent prescribed by Form 5472 (or any successor form), instructions to the form, publication, or other guidance published in the Internal Revenue Bulletin.

* * * * *

(g) * * * Paragraph (b)(5)(iv) of this section applies with respect to information for annual accounting periods beginning on or after March 4, 2019.

Douglas W. O’Donnell,
Acting Deputy Commissioner for Services and Enforcement.

Approved: June 12, 2020.

David J. Kautter
Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2020–14649 Filed 7–9–20; 11:15 am]