

FDII Documentation Requirements Relaxed

July 20, 2020

Final regulations released July 9, 2020 provide guidance regarding the deduction for foreign-derived intangible income (“FDII”). The highly anticipated guidance includes substantially relaxed documentation rules for claiming the FDII deduction. Taxpayers considering a FDII deduction should implement procedures to gather and retain the information necessary to meet the new substantiation requirements.

I. Background

Section 250 permits a domestic corporation to deduct an amount equal to 37.5% of the corporation’s FDII. Income is eligible for the FDII deduction only if derived from:

- services rendered to any person, or with respect to property, not located in the United States; or
- property sold, leased, licensed, exchanged or otherwise disposed of to any person who is not a United States person, and is for a foreign use.

The rules for determining and documenting the existence of these requisite facts depend on the type of services or property. For purposes of applying the regulations, each service is placed in one of five categories: (1) property services, (2) proximate services, (3) transportation services, (4) general services (any services not otherwise categorized, including advertising services and electronically supplied services) to consumers, and (5) general services to business recipients; and property sold is categorized as either intangible property or general property (any property other than intangible property, securities, interests in a partnership, trust, or estate, and certain commodities).

Proposed regulations, published March 6, 2019, contained extensive and detailed, not to mention mandatory, documentation rules for establishing the requisite foreign status of a person, foreign use of property, or foreign location of a customer, recipient, or property.

Taxpayers and practitioners voiced concern that the proposed documentation requirements were too rigid (*e.g.*, only a limited set of enumerated documents were permitted as substantiation) and difficult, if not impossible, to obtain in the ordinary course of business. Treasury and IRS heeded many of these concerns and reworked the documentation rules, providing taxpayers more flexibility in substantiating FDII deductions.

II. Final Regulations Regarding Documentation

A. Three Key Changes

1. Elimination of Specific Documentation Requirements in Certain Instances

The final regulations eliminate the specific documentation requirements for purposes of establishing 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. Where the final regulations adopt no specific substantiation requirements, the general requirements that taxpayers must keep permanent records that are sufficient to establish the amount of any deduction claimed on a return control. Under the final rules the burden therefore remains with the taxpayer, but a broader range of evidence may be used as substantiation.

The final regulations also provide presumptions of facts in specified circumstances, such as presumption of foreign person status. For example, a purchaser of property is presumed to be a foreign person in the case of foreign retail sales; non-retail foreign sales of general property delivered (such as through a commercial carrier) to the recipient or end-user at an address outside the United States; and sales of intangible property and certain sales of general property to recipients with billing addresses outside the United States. However, these presumptions will not apply if the seller knows or has reason to know that the sale is not to a foreign person based on information received as part of the sales process.

2. Increased Flexibility for Remaining Specific Documentation Requirements

To support other facts—*i.e.*, foreign use for sales of general property for resale, foreign use for sales of general property subject to manufacturing, assembly, or processing outside the United States, foreign use with respect to sales of intangible property, and whether services are performed for business recipients located outside the United States—the final regulations adopt a more flexible approach to substantiation. Rather than limiting substantiation to a narrow set of specified documents, the regulations focus on the nature of the information required. For example, foreign use with respect to sales to resellers can be substantiated by a contract limiting sales to outside of the United States, proof that the property is only suited to a foreign market, or proof that shipping costs would be prohibitively expensive if sold back to the United States. The final regulations also forgo the proposed regulations' stringent three-prong reliability test for documents used as substantiation, though they still require substantiating documents to be supported by "credible evidence" and, in general, in existence by the time the taxpayer files its return (including extensions).

3. Transitional Rule Extended, as Requested

The final regulations regarding substantiation are applicable to taxable years beginning on or after January 1, 2021. For all taxable years beginning before January 1, 2021, taxpayers may choose to rely on the final regulations (provided they are applied in their entirety with some exception) or the proposed regulations, including the transitional rule contained in the proposed regulations that was originally applicable only for taxable years beginning on or before March 4, 2019. The transitional rule permits taxpayers to use any reasonable documentation maintained in the ordinary course of the taxpayer's business to establish foreign person status, foreign use, or location of service recipient.

B. Additional Considerations

1. New Rules for Digital Content and Electronically Supplied Services

In response to ambiguities and gaps identified in the proposed regulations, the final regulations include

additional guidance with respect to the determination of foreign person status and foreign use for the sale of digital content as well as services that are provided electronically. For example, the final regulations clarify that the rules for sales of general property, not the rules for sales of intangible property, apply for purposes of determining foreign use for sales of digital content, including copyrighted articles, transferred electronically. In fact, the general property sales rules now contain a special rule for digital content that carries a different substantiation burden than other rules such as those for intangibles.

2. Small Business Exception Expanded

The final regulations expand the availability of the small business exception from the specific documentation requirements described above. The heightened requirements 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. Under the proposed regulations the cutoff was \$10,000,000 in gross receipts.

III. Final Thoughts

While generally desired and welcomed, flexibility for taxpayers such as that provided in the final FDII documentation rules also leaves room for uncertainty in applying such rules to complex and unique facts and circumstances. Attorneys in Caplin & Drysdale's International Tax practice group are available to discuss these final regulations and to analyze how to effectively and efficiently substantiate FDII deductions.

For more information on this Alert, please contact a member of [Caplin & Drysdale](#).

[J. Clark Armitage](#)
carmitage@capdale.com
202.862.5078

[Jonathan S. Brenner](#)
jbrenner@capdale.com
212.379.6050

[Amanda M. Leon](#)
aleon@capdale.com
202.862.7861



About Caplin & Drysdale

Having celebrated our 50th Anniversary in 2014, Caplin & Drysdale continues to be a leading provider of legal services to corporations, individuals, and nonprofits throughout the United States and around the world. We are also privileged to serve as legal advisors to accounting firms, financial institutions, law firms, and other professional services organizations.

The firm's reputation over the years has earned us the trust and respect of clients, industry peers, and government agencies. Moreover, clients rely on our broad knowledge of the law and our keen insights into their business concerns and personal interests. Our lawyers' strong tactical and problem-solving skills - combined with substantial experience handling a variety of complex, high stakes, matters in a boutique environment - make us one of the nation's most distinctive law firms.

With offices in New York City and Washington, D.C., Caplin & Drysdale's core practice areas include:

- [Bankruptcy](#)
- [Business, Investment & Transactional Tax](#)
- [Complex Litigation](#)
- [Corporate Law](#)
- [Employee Benefits](#)
- [Exempt Organizations](#)
- [International Tax](#)
- [Political Law](#)
- [Private Client](#)
- [Tax Controversies](#)
- [Tax Litigation](#)
- [White Collar Defense](#)

For more information, please visit us at www.caplindrysdale.com.

Washington, DC Office:

One Thomas Circle, NW
Suite 1100
Washington, DC 20005
202.862.5000

New York, NY Office:

600 Lexington Avenue
21st Floor
New York, NY 10022
212.379.6000

Disclaimer

This communication does not provide legal advice, nor does it create an attorney-client relationship with you or any other reader. If you require legal guidance in any specific situation, you should engage a qualified lawyer for that purpose. Prior results do not guarantee a similar outcome.

Attorney Advertising

It is possible that under the laws, rules, or regulations of certain jurisdictions, this may be construed as an advertisement or solicitation.

© 2020 Caplin & Drysdale, Chartered
All Rights Reserved.