International Tax Alert

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Can you get your tax rate to 13.125 percent?

IRS issues proposed regulations on Section 250 for foreign-derived intangible income deduction

The IRS has released proposed regulations to help eligible taxpayers calculate their deduction for foreign-derived intangible income (FDII).

The proposals are intended to:

- Guide taxpayers on the calculation for FDII and determine qualifying sales.
- Provide clarity on FDII reporting requirements for partnerships that have either direct or indirect C corporation partners.

What is FDII?

The FDII regime was introduced by the Tax Cuts and Jobs Act of 2017 (TCJA) and offers a new deduction only available to U.S. C corporations. The deduction provides a valuable planning opportunity for U.S. C corporations with foreign customers to reduce their effective tax rate on qualifying income from 21 to 13.125 percent for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026. The effective rate on qualifying income for tax years beginning after Dec. 31, 2025 is reduced to 16.406 percent. FDII is intended to incentivize corporations to base income-generating intangible property (IP) in the United States and reverse the trend of corporate IP migration. However, the deduction is available to all C corporations that have qualifying foreign sales of goods and services, even those without significant IP.

The deduction is 37.5 percent of a corporate taxpayer's intangible income attributable to qualifying foreign sales through 2025 (after which, the deduction percentage decreases to 21.875 percent). Intangible income for purposes of FDII is imputed as net income (after certain exclusions) less 10 percent of tax basis in production assets computed under the Alternate Depreciation System (ADS).

Key takeaways on the proposed Sec. 250 regulations for deduction on FDII

- **FDII eligibility for sales of products:** Eligible sales include leases, licenses, exchanges, or other dispositions of products to a foreign person for use outside the United States. The proposals clarify who constitutes a foreign person and provide rules on ultimate foreign use and further modification. The proposals also introduce strict documentation requirements to substantiate qualifying sales, with less rigorous documentation allowable under limited circumstances. In general, if documentation requirements are met, sales of any tangible property to foreign customers for use outside the United States will be qualified for FDII.
- **FDII eligibility for sales of services:** Eligible income may be earned from the provision of services to customers outside the United States. The proposals categorize services into four different classes with different qualifying rules for each. Generally, all four classes qualify only if the service recipient is located outside the United States, regardless of whether the recipient is a foreign person. The performance of the services may take place within or outside the United States. As with sales of products, the proposals outline specific documentation required to substantiate qualified sales of services.
- **FDII eligibility on royalties and sales of IP:** Royalties for use of IP outside the United States is generally qualified for FDII. Royalties for use of IP both within and outside the United States may be partially qualified under the proposals provided; the seller can establish the proportionate foreign use. The proposals also clarify that sales of IP can be FDII-qualified to the extent revenue is earned from exploiting the IP outside the United States.
- **Related-party rules:** The proposals clarify that sales of products to foreign-related parties must be resold to unrelated foreign parties and properly documented *prior* to the filing of the tax return claiming the deduction (amended returns are allowable for subsequent sales occurring before the tax return statute expiration). For services, the proposals provide further explanation as well as a bright-line test for taxpayers to determine when related-party services fail to qualify for FDII due to the related party providing "substantially similar" services to persons within the United States.
- **Consolidated group reporting and ordering rules:** The proposals confirm that the FDII deduction is computed at the consolidated group level. Additionally, the proposals provide ordering rules for taxpayers with Sec. 163j limitations or net operating loss carryforwards to compute their FDII deduction.
- **Reporting requirements for partnerships:** The proposals confirm that a C corporation partner may compute a FDII deduction using its proportionate share of partnership FDII attributes. Partnerships with

direct or indirect C corporation partners would be required to calculate FDII attributes and report them on Schedule K-1.

- **Anti-abuse rules:** The proposals outline anti-abuse rules applicable to several components of the FDII calculation, including rules intended to prevent planning strategies by taxpayers to reduce their fixed asset limitation.

Closing thoughts

C corporations: The proposals offer generally favorable rules for C corporations, allowing for Sec. 250 benefits computed using allocations from partnership interests. While FDII oftentimes requires a complex calculation, as well as documentation that may be highly burdensome, the benefit of an effective 13.125 percent federal tax rate on FDII should greatly outweigh the costs for many taxpayers. FDII presents a tremendous planning opportunity for C corporations with foreign sales.

Partnerships: The K-1 disclosure requirements have the potential to greatly increase the compliance burden on partnerships with direct or indirect C corporation partners. As currently drafted, the proposed regulations would, in most cases, require such partnerships, *even those with no foreign activity*, to undertake a complex calculation to compute FDII components, including a recomputation of depreciation schedules to an ADS basis solely for K-1 disclosure purposes.

If you have any questions about whether you qualify for the FDII deduction, or any questions regarding how FDII may impact your tax situation, please contact your international tax specialist.

If you have any questions, please contact:

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