



KPMG report: Initial impressions, observations on proposed FDII, GILTI regulations under section 250

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Introduction

The U.S. Treasury Department and IRS on March 4, 2019, released proposed regulations (REG-104464-18) relating to the deduction for “foreign-derived intangible income” (FDII) and “global intangible low-taxed income” (GILTI) under section 250.

The [proposed regulations](#) [PDF 446 KB] (47 pages) were published in the Federal Register on March 6, 2019.

This report provides initial impressions and observations about these proposed rules.

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Applicability dates and reliance

The applicability dates for the proposed rules generally fall into three categories:

- Tax years ending on or after March 4, 2019, for the general FDII deduction rules
- Consolidated return years ending on or after the date the final regulations are published in the Federal Register for the consolidated return rules
- Annual accounting periods beginning on or after March 4, 2019, for the information reporting rules

Nevertheless, taxpayers would not be required to follow the documentation requirements in the proposed regulations (discussed below) for tax years beginning on or before March 4, 2019. Instead, the proposed regulations allow a taxpayer to use any reasonable documentation maintained in the ordinary course of the taxpayer's business that establishes, with respect to property transactions, that a recipient is a foreign person and that the property is for a foreign use, or with respect to services, that a recipient of a general service is located outside of the United States. This documentation must still satisfy the reliability requirements set forth in the proposed rules.

Significantly, taxpayers are permitted to rely on the proposed regulations for tax years ending before March 4, 2019, without any explicit requirement to consistently apply all of the proposed rules.

Comment period and hearing

The preamble to the proposed regulations includes over 20 requests for comments. Any comments or requests for a public hearing must be submitted by May 6, 2019.

Background

The new U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017) made a number of significant changes to the U.S. international tax system, including the enactment of the FDII and GILTI regimes. The FDII regime provides a preferential U.S. effective tax rate to U.S. corporations on certain income, by means of a deduction under section 250. Specifically, U.S. corporations may be entitled to a deduction based on their "foreign-derived deduction eligible income" (FDDEI), which is income from certain sales or licenses of property to foreign persons for foreign use and services provided to persons, or with respect to property, located outside the United States. The benefit of the deduction is reduced by 10% of the amount of the corporation's "qualified business asset investment" (QBAI), which generally is depreciable tangible property used in the production of "deduction eligible income" (DEI). DEI generally consists of all of a corporation's gross income, other than a few exempt items, reduced by allocable deductions.

Similarly, a U.S. corporation may be entitled under section 250 to a deduction of up to 50% of its GILTI inclusion and related section 78 gross-up. Proposed regulations issued last year addressed a number of questions relating to the calculation of a U.S. shareholder's GILTI inclusion. [Read [TaxNewsFlash](#) for KPMG's report that examines the GILTI proposed regulations.] The GILTI proposed regulations did not, however, address the U.S. shareholder's deduction under section 250.

Overview of the proposed regulations

FDII computation issues - taxable income limitation

The FDII deduction is subject to a taxable income limitation, which generally reduces the section 250 deduction when the taxpayer's FDII and GILTI inclusions exceed its taxable income.

- **Treatment of section 78 gross-up:** Notably, the statute does not take into account the section 78 gross-up attributable to the GILTI inclusion amount when applying the taxable income limitation. The Joint Committee on Taxation's explanation of Pub. L. No. 115-97 described an intent to include the section 78 gross-up in the taxable income limitation, but noted that a technical correction may be necessary to reflect the intent. A revision to the statute that would effectuate this intent is included in the Ways and Means Committee then-Chairman Kevin Brady's discussion draft of a technical corrections bill ("Tax Technical and Clerical Corrections Act Discussion Draft" dated January 2, 2019). The proposed regulations are consistent with the statute, and apply the taxable income limitation by reference only to the FDII and GILTI inclusion amounts, and reduce only the portion of the section 250 deduction attributable to FDII and GILTI inclusions—and not the related section 78 gross-up—when the limitation does apply.

KPMG observation

To the extent a taxpayer's section 250 deduction is limited under the taxable income limitation, accounting methods planning may be used to increase taxable income, provided the collateral impacts on all other tax attributes are considered. Accounting methods planning can also be used to reduce a taxpayer's QBAI, resulting in an increased FDII deduction. Any accounting methods planning should be done while maintaining a holistic perspective of the taxpayer's tax profile, as this type of planning has the potential to be either beneficial or detrimental in the context of other tax provisions.

FDII computation issues—allocation of deductions

The initial statutory building block in the FDII regime is the definition of DEI. The statute defines DEI as the excess (if any) of gross income determined without regard to certain specified classes of gross income, reduced by properly allocable deductions—with the result that DEI represents a net income concept. FDDEI is then defined as "any" DEI that is foreign-derived.

- **Direct allocation approach:** The statutory language was unclear regarding whether the computation of FDDEI was determined by apportioning DEI between its FDDEI and non-FDDEI components (for example, based on sales, gross income, or another metric) or alternatively, whether to determine FDDEI by requiring a separate direct allocation of deductions to gross income qualifying as FDDEI. The proposed regulations resolve the ambiguity by taking the latter approach.
- **Capping FDDEI at DEI:** The direct allocation approach means that it is possible for a taxpayer to have a loss for non-foreign DEI (broadly speaking, income from the U.S. market), while earning positive FDDEI. This possibility raises a question regarding whether the amount of FDDEI could exceed DEI, due to the statutory description of FDDEI as "any" DEI. The proposed regulations resolve this

uncertainty by limiting the amount of FDDEI to the amount of DEI. Therefore, losses in the domestic market can impact the computation of FDII even when the taxable income limitation is not implicated (for example, if losses attributable to non-foreign DEI exceed FDDEI, then no FDII benefit is available at all).

KPMG observation

The policy basis for reducing the FDII benefit through a DEI limitation when a taxpayer has domestic losses (that is, negative non-FDDEI) and positive FDDEI is not clear. The statute seems aimed at providing a benefit based on positive FDDEI, and includes a separate taxable income limitation that could limit the FDII deduction based on domestic losses. Further, the requirement to separately allocate expenses to gross FDDEI seems inconsistent with the view that FDDEI is limited to DEI.

- **Application of section 861 for allocating deductions:** The statute requires gross DEI to be reduced by the deductions (including taxes) properly allocable to gross DEI, but the statute is silent as to the methodology for allocating the deductions. As widely expected, the proposed regulations generally treat section 250 as an operative section for purposes of section 861, and thus allocate expenses for both DEI and FDDEI purposes under the section 861 regulations—except that the “exclusive apportionment” rule for apportionment of research expenses under Reg. section 1.861-17(b), which applies for purposes of an apportionment based on “geographic sources,” does not apply.

KPMG observation

The use of the section 861 rules was foreshadowed in Prop. Reg. section 1.861-8(d)(2)(ii)(C)(4), included in the proposed foreign tax credit regulations. That proposed rule would provide that “for purposes of determining deduction eligible income under the operative section of section 250(b)(3),” the proposed exempt income and exempt asset rules under section 864(e)(3) would not apply. The reference to section 250(b)(3) as an operative section under section 861 in the proposed foreign tax credit regulations—which are proposed to have an applicability date that is earlier than the applicability date of the section 250 proposed regulations—raises the question of whether the effect of this reference is to require the application of section 861 to any tax years to which the foreign tax regulations apply but the section 250 regulations do not apply.

FDII computation issues—COGS

In order to determine FDDEI and DEI, a taxpayer must determine its **gross income** from eligible sources. This raises the question of how cost of goods sold (COGS) are allocated. For this purpose, the proposed regulations generally allow a taxpayer to attribute COGS between gross DEI and gross FDDEI using any reasonable method. The proposed regulations explicitly provide, however, that COGS must be attributed to gross receipts with respect to gross DEI and gross FDDEI regardless of whether certain costs included in COGS can be associated with activities undertaken in an earlier tax year (including a year before the effective date of section 250). For example, if a taxpayer has environmental remediation expenses associated with a 2015 event, any associated expenses will be capitalized to inventory and recognized as COGS as a result of section 263A. Even though the event generating the environmental remediation liability occurred prior to the effective date of section 250, the expenses will be attributed

to gross DEI and gross FDDEI.

- **Parallels with section 199—and differences:** There are many parallels between the section 250 proposed regulations and the rules applied in calculating the domestic production activities deduction under former section 199. The treatment of COGS and the apportionment and allocation of deductions under the proposed section 250 regulations are consistent in many respects with the treatment of COGS and deductions under section 199. An important difference, however, relates to the proposed rules' special prohibition on tracing components of current-year COGS to pre-effective date years. The regulations under former section 199 did not include any such rule, although that was the government's position as articulated in less formal guidance.

KPMG observation

In contrast to the COGS attribution, the proposed rules do not prevent a facts-and-circumstances-based allocation of below-the-line expenses away from DEI and FDDEI under the principles of section 861. Therefore, taxpayers can evaluate below-the-line deductions to determine whether any of those are attributable to revenue that accrued prior to the effective date of section 250. Pension expense is a common example of an expense that can be partially attributed to activities that occurred in the years before the expense is incurred.

FDII computation issues—exclusions from DEI for foreign branch income

One of the items excluded from DEI is foreign branch income, defined in the statute by cross-reference to section 904(d)(2)(J), which defines “foreign branch income” for purposes of the new foreign tax credit basket for such income. Proposed regulations under section 904(d)(2)(J) provide additional guidance on determining foreign branch income for “foreign tax credit” (FTC) purposes.

- **Definition of “foreign branch income”:** As a result of the straight cross-reference to the section 904 rule, one might have expected that “foreign branch income” would have the same definition for FTC and FDII purposes. Nonetheless, although the FDII proposed regulations generally cross-reference the definition in the proposed FTC regulations, they also include an additional rule that would treat income from the sale of assets that produce gross income attributable to a branch (for example, by reason of the sale of a disregarded entity or partnership interest) as foreign branch income for FDII purposes.

KPMG observation

It seems likely this difference was driven by the different policy considerations underlying the FDII rules and FTC branch rules. The FDII rules have their genesis in moderating the tax incentives that otherwise exist to shift certain domestic income offshore, while the FTC branch rules are more focused on when a foreign country is likely to impose net basis tax on the operations of a U.S. company. Nonetheless, commentators are sure to question the ability of the regulations to provide a different meaning of foreign branch income for purposes of section 250 when the statute defines it by cross reference to the foreign tax credit rules.

QBAI

The statute defines QBAI by cross-reference to the definition of the term in section 951A (the GILTI provisions).

- **FDII-specific QBAI rules:** Rather than cross-reference the GILTI proposed regulations on QBAI, however, the FDII proposed regulations include separate rules on QBAI, which are largely consistent with the QBAI rules in the GILTI proposed regulations. The anti-abuse provisions in the two sets of proposed QBAI rules are different, reflecting the positive effect of QBAI for GILTI purposes, and the negative effect of QBAI for FDII purposes. Under the FDII proposed regulations, the anti-avoidance rules are aimed at transactions that **reduce** QBAI (including certain sale-leaseback transactions engaged in with a principal purpose of decreasing QBAI).

Consolidated return rules

The proposed regulations include guidance for determining the amount of the section 250 deduction for taxpayers that file consolidated returns.

- **Consolidated approach:** The proposed rules contain new consolidated return regulations providing for the computation of the section 250 deduction on an aggregate, group-wide basis, with rules allocating the deduction among group members.
- **Attribute redetermination:** The proposed rules add a new example to the intercompany transaction regulations that demonstrates how the intercompany transaction-attribute-redetermination rules can be used to alter both the characterization of intercompany amounts and expense allocation to allow for the same aggregate section 250 treatment as would obtain if the intercompany transactions were between divisions of a single entity. The preamble emphasizes that this new example is merely an application of existing intercompany transaction law, suggesting a far-reaching government view of the scope of the existing intercompany transaction rules.
- **Intercompany QBAI transactions:** The proposed rules include a special rule providing that basis adjustments attributable to intercompany transactions are disregarded in determining QBAI.

FDDEI transactions

A critical element of the FDII deduction is the computation of FDDEI—a subset of DEI that relates to income from certain 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 proposed rules refer to these transactions individually as “FDDEI sales” and “FDDEI services” and collectively as “FDDEI transactions.”

The proposed rules provide guidance to assist taxpayers in determining and documenting whether a sale or service transaction is a FDDEI transaction, including a number of general operating rules related to all FDDEI transactions as well as specific rules for FDDEI sales and FDDEI services.

Operating rules

The proposed regulations include operating rules to assist taxpayers in determining whether a sale or service transaction is a FDDEI transaction, as well as extensive rules on documentation to substantiate a FDDEI transaction.

The statute requires that a taxpayer establish the “foreign use” of property in order for a sale to qualify as a FDDEI sale, as well as to establish that a service is provided to a person, or with respect to property, located outside the United States in order for a service to qualify as a FDDEI service, but does not provide any guidance on documentation standards. The proposed rules include a number of specific documentation requirements to satisfy specific elements (foreign use, foreign person, and foreign location). The proposed rules also include a “reason to know” standard (as of the date of filing the relevant tax return) for determining the reliability of the documentation.

- **FDDEI loss transactions:** As a result of the requirement under the statute for the taxpayer to “establish” the various statutory elements of a FDDEI transaction, the FDII deduction arguably could be affirmatively avoided by failing to document that the transaction satisfies the FDDEI rules. The proposed rules seem to provide otherwise, by providing that FDDEI treatment is not avoided through a lack of documentation. The preamble indicates that this rule is intended to prevent taxpayers from excluding loss transactions in the computation of FDDEI.

KPMG observation

This prohibition could imply that the FDII deduction is not elective and may need to be claimed even if the deduction results in negative tax consequences, for example, as a result of the treatment of the related deduction under a foreign tax law that denies deductions for amounts that benefit from certain preferential regimes.

- **Predominant character:** The proposed rules would characterize a transaction that contains elements of both sales and services as either a sale or a service based on the predominant character of the transaction. In contrast, similar rules in section 199, Reg. section 1.861-18, and section 954 generally require the disaggregation of transactions into separate components. See Reg. sections 1.199-3(d)(3), 1.861-18(b)(2), and 1.954-1(e)(3).
- **Partnerships:** Under the proposed rules, a partnership is treated as a person for purposes of determining whether sales or services qualify as FDDEI. The proposed rules impose a requirement on the partnership to determine the various elements of the FDII computation (gross DEI and allocable deductions, gross FDDEI and allocable deductions, and QBAI) at the partnership level, and to include the information on the Schedule K-1 for any direct or indirect corporate partners.
- **Fungible property:** The proposed rules specifically address the sale of fungible property. In the case of sales of multiple items of general property, which because of their fungible nature cannot reasonably be traced to the location of use, the seller may establish that a portion of the “fungible mass” is for a foreign use through various market research tools.

FDDEI sales

The statute provides that income from the sale or license of property to a foreign person for foreign use is FDDEI, and includes special rules for related-party transactions. Although the taxpayer has the burden of proving foreign use in order to claim a FDII deduction, the statute does not contain any guidance on documentation that would establish foreign use. The proposed rules provide new provisions for determining FDDEI sales, as well as separate rules on documentation that establishes the elements of a FDDEI sale.

- **Foreign person and foreign use standards:** The proposed rules maintain a single standard for determining and documenting whether property sales and licenses are **to a foreign person**, but set forth different “foreign use” standards and documentation rules for intangible property (IP) (defined by reference to section 367(d)(4)), “general property,” and property used to transport people or property.
- **Financial instruments:** The proposed rules preclude FDDEI treatment for sales of certain financial instruments, defined by cross reference to certain section 475 rules to include stock, currency, and certain financial instruments with respect to actively traded commodities (but not the commodities themselves) under a view that these financial instruments cannot satisfy the foreign use requirement.

KPMG observation

The view expressed in the preamble that the financial instruments cannot satisfy the “foreign use” requirement could create an inference that all financial instruments and similar items are excluded from FDDEI. Alternatively, the arguably exclusive definition of stocks and commodities in the proposed regulations could be interpreted as permission to treat a financial instrument or similar item that is not described in the proposed regulations as satisfying “foreign use” if appropriate documentation establishing foreign use under the proposed regulations was obtained.

- **Foreign use of IP:** The statute provides no guidance on determining “foreign use” other than generally defining the term to mean use, consumption, or disposition that is not within the United States. In the absence of guidance, authorities for determining the source of royalty income would appear relevant for determining the foreign use of IP for purposes of section 250, due to the similar language in the sourcing rules for royalties (sections 861(a)(4) and 862(a)(4)) and the FDII rules. Consistent with that view, the proposed rules include a general standard for determining foreign use based on whether the IP is exploited outside the United States. The proposed rules also include, however, a specific standard for determining the foreign use of IP that is used in the development, manufacture, sale, or distribution of a product, which provides that such IP is treated as exploited at the location of the end user to which the product is sold. This proposed rule would appear to deviate from the general sourcing rule for certain types of IP—in particular manufacturing process IP. The proposed rules do not explicitly apply the “end user” standard to determine the foreign use of IP that is used to provide a service.

KPMG observation

In light of the similarity between the statutory rules for determining FDII and sourcing royalties, the FDII proposed rules raise the question whether Treasury and the IRS will interpret the sourcing rules in the future in a manner similar to the FDII proposed regulations (for example, sourcing royalties from manufacturing IP based on the location of the end user of the manufactured product). On the other hand, the lack of a similar end-user rule in the proposed rules for IP used to provide a service to a recipient could indicate that the special end-user standard applies solely for FDII purposes, and only to determine the foreign use of IP that is used to develop, manufacture, sell, or distribute a product to an end user.

- **Lump-sum payments.** The application of the statutory foreign use standard when IP is sold for a lump-sum payment is unclear, because the determination of whether the sale qualifies for the FDII deduction must be made in the year of the sale, but the use of the IP may not occur until years after the sale. To this end, the proposed rules provide a specific “foreign use” standard for lump-sum sales of IP, which is based on a determination of the net present value of revenue the seller would have reasonably expected to earn from the exploitation of the IP outside the United States over the total expected revenue from the exploitation of the IP.
- **Foreign use of general property, three-year rule:** “General property” is property other than IP and property that is used in the transportation of people or property. The proposed rules provide an inexplicably onerous standard under which general property that is not subject to further manufacturing is only considered sold for a foreign use if the property is not subject to a domestic use for three years after the property is delivered. The proposed rules list types of documentation that would establish the satisfaction of this standard, including documentation of shipment of the property to a location outside the United States.

KPMG observation

The interaction of the three-year rule with the documentation requirements is unclear, and raises issues as to whether the documentation rule subsumes the three-year period rule. Is the foreign use standard always satisfied when the documentation rule is satisfied and there was no reason to know of any expected domestic use as of the filing date, even if domestic use actually occurs within the three-year period?

- **Foreign use of general property, further manufacturing:** Although the statute did not provide specific guidance on foreign use, the Conference Report to Pub. L. No. 115-97 states that foreign use would be satisfied when the relevant property is subject to manufacture outside the United States after its sale. Consistent with the legislative history, the proposed rules provide that the further manufacture of property outside the United States prior to any domestic use of the property constitutes foreign use. For this purpose, the proposed rules contain a subjective facts-and-circumstances test based on a physical and material change to the property, and an objective component-part test, which would apply when the fair market value of the property is no more than 20% of the final product into which it is incorporated.

KPMG observation

Although the proposed rules do not cross reference or otherwise refer to the manufacturing rules in the subpart F foreign base company sales income regulations, there are similarities between the proposed rules and the “substantial transformation” and “component part” rules in Reg. section 1.954-3(a)(4). In contrast, the proposed rules do not contain rules similar to the “substantial contribution” rules that are part of the same foreign base company sales income regulation, perhaps because only the location of manufacture—and not the identity of the manufacturer—is relevant to the foreign use determination.

The analysis is also reminiscent of the section 199 analysis to determine whether a product was domestically manufactured or produced in whole or significant part in the United States. There is beneficial case law under section 199 that establishes a fairly low bar for these activities. See *Dean Foods v. United States*, *Precision Dose v. United States*.

- **Arms Export Control Act:** Although sales to a U.S. person are not eligible for FDDEI, the proposed rules allow certain sales of property to the U.S. government under the Arms Export Control Act of 1976 to be eligible for FDDEI treatment by effectively viewing the U.S. government as a conduit, and treating the foreign government to whom the property is on-sold as the purchaser of the property for FDII purposes. The proposed rules are consistent with the Joint Committee on Taxation’s report, which states that FDDEI treatment is available when the U.S. government acts purely as an intermediary in certain transactions involving foreign entities, such as certain foreign military sales. The Joint Committee report also notes that a technical correction may be necessary for this treatment.

FDDEI services

The statute provides that services provided to a person, or with respect to property, located outside the United States are FDDEI, and includes special rules for related-party transactions.

- **Five categories of FDDEI services:** The proposed rules interpret the statute to provide mutually exclusive tests for determining FDDEI from services that are provided to persons or with respect to property. The proposed rules further divide the universe of FDDEI services into five mutually exclusive categories, each of which have their own rules for determining FDDEI eligibility. In order of priority, the categories are: (i) transportation services; (ii) services (other than transportation services) provided to tangible property at or near the location of the property (“property services”); (iii) “proximate services,” which generally are services (other than transportation or property services) performed in the physical presence of a person; (iv) residual services (services that are not transportation, property, or proximate) provided to individuals for personal use; and (v) residual services provided to business recipients (recipients other than individuals who purchase services for personal use).
- **Location standards:** Generally, under the proposed rules: (1) the location of transportation services is determined based on the origin and destination of the transportation of the person or property, with a 50/50 split between domestic and foreign when either the origin or the destination (but not both) are outside the United States; (2) the location of property services is determined based on the location of the tangible property (regardless of the location of the recipient of the services); and (3) the location of proximate services is determined based on the location where the service is

performed. With respect to general services provided to individuals for personal use, the location of the service is determined based on the individual's residence at the time of the service. Finally, the proposed regulations determine the location of general services provided to a business recipient based on the benefit conferred on the business recipient's fixed places of business, which can be established under a variety of prescribed methods.

KPMG observation

In contrast to the other types of services, for general services, the proposed regulations require documentation in order to establish the location of the recipient. The proposed regulations provide that documentation establishing the location of a business recipient includes publicly available information about the recipient.

KPMG observation

One favorable difference between section 250 and section 199 relates to the treatment of online software, which follows from the fact that, in contrast to section 199, services are generally eligible for benefits under section 250. Under section 199, the regulations permitted a taxpayer to treat the sale of online software as eligible for section 199 only if certain stringent requirements were satisfied, and these criteria have been the source of ongoing controversy between taxpayers and the IRS. Because section 250 generally applies to income from the delivery of services, this controversy is eliminated under section 250, with a new focus on the location of the consumer or business recipient of the service.

- **Arms Export Control Act:** The proposed regulations provide that certain services purchased by the U.S. government under the Arms Export Control Act of 1976 for on-service to a foreign government are eligible for FDDEI treatment, in the same manner that sales under the act are eligible for FDDEI sales treatment.

Related-party transactions

Section 250 treats sales and services made to related foreign parties as not for a "foreign use" unless additional requirements are satisfied. In general, in the case of related-party sale transactions, property is not treated as sold for a foreign use unless it is subsequently sold to an unrelated party for a foreign use or used by a related party in connection with property that is sold, or the provision of services to, an unrelated foreign person for foreign use. In the case of related-party service transactions, the service is not considered a FDDEI service if the foreign related person performs substantially similar services for persons located within the United States. The proposed regulations provide guidance on the application of the related-party rules, including helpful guidance that narrows the application of those rules.

- **Related-party rules, FDDEI sales:** Under the proposed rules, no special related-party rules apply to sales that involve IP because the proposed rules for determining foreign use of IP (which apply to transactions with both related and unrelated persons) are viewed as sufficient to effectuate the policy behind the related-party rules. For all other property, the proposed rules require the ultimate sale to an unrelated foreign person to occur prior to the filing of the return that includes the income from the sale to the related party. If the unrelated-party sale occurs subsequent to the filing date, the FDII

deduction can be claimed for the year of the sale to the related party in an amended return (provided the statute of limitations is open).

- Related-party rules, FDDEI services:** Perhaps more significantly, the proposed regulations apply the “substantially similar” related-party rule for services only to general services provided to a related business recipient (“related-party services”), and narrow the scope of the application of the rule. As a threshold issue, the proposed rules apply the related-party rule only to services that are actually used by the related party in the provision of services to persons located in the United States. Thus, the proposed rules replace the subjective determination of whether any service is “substantially similar” to a service provided by the related party to a person located in the United States with an inquiry into whether the particular service is “used” by the related party in providing services to a person located in the United States. Further, the related-party rule applies to a particular related-party service only if the related party uses the service to provide a service (the “related service”) and either (i) at least 60% of the benefit of the related service is provided to persons located in the United States (“benefit test”); or (ii) at least 60% of the price paid for the related service is attributable to the related-party service (“price test”). The full amount of the related-party service income is disqualified from FDDEI if the benefit test is failed. If only the price test is failed, however, only the portion of the related-party service income that corresponds to the portion of the related service that benefitted persons located in the United States (under the benefit test) is disqualified from FDDEI.

KPMG observation

Because the related-party service rule is based on the relative benefit provided by the related party to persons located in the United States, a taxpayer cannot improve its position under the benefit test by having the related party bundle high value services with the related-party service, even though the bundling would improve its position under the price test.

KPMG observation

The statute could have been interpreted as having a cliff effect, such that related-party services would be disqualified if a related recipient of services provided a de minimis amount of substantially similar services to a person located in the United States. This result would not occur under the proposed regulations. For example, assume that USS provides \$75 of services to FP (a foreign related party). FP uses the related-party service to provide \$90 of services to X, a customer located outside the United States, and \$10 of services to Y, a customer located in the United States. Although USS would pass the benefit test because 90% ($90/(90 + 10)$) of the benefits are provided by FP to persons located outside the United States, USS would fail the price test because 75% ($75/100$) of the price paid by FP’s customers for FP’s service is attributable to the services provided by USS to FP. As a result, the \$75 of services income treated as FDDEI services is reduced to \$67.50 based on the portion of the total benefit provided by FP to persons located outside the United States ($\$75 \times 90/100 = \67.50), rather than being fully disallowed as would occur under a “cliff effect” rule.

Section 962 election

Although the section 250 deduction generally is available only to corporations, the proposed rules allow

U.S. individuals, trusts, and estates that make a section 962 election with respect to a controlled foreign corporation to take into account the section 250 deduction applicable to GILTI inclusions and the related section 78 gross-up in determining the amount of tax imposed on their GILTI inclusions under the section 962 rules. This favorable rule would make the section 962 election beneficial to a broader range of individuals, trusts, and estates. Although the rule is proposed to apply to tax years that end on or after March 4, 2019, taxpayers can rely on the proposed regulations for tax years that end before March 4, 2019.

Information reporting

The proposed rules contain a number of information reporting requirements, which are largely consistent with relevant forms previously released by the IRS.

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