UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20044

RE: IRS REG-104464-18 – Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

Dear Commissioner Rettig:

USCIB[1] is pleased to provide comments on the proposed regulations regarding the deduction for foreign-derived intangible income ("FDII") and global intangible low-taxed income (GILTI") (IRS REG-104464-18). USCIB believes that regulations are generally clear and follow the statutory structure.

General Comments

The government has stated that it will reexamine approaches for allocating expenses including interest, research and experimentation, stewardship, and general and administrative expenses. USCIB strongly encourages this reexamination given the systemic changes to the international tax system. The current rules governing the allocation and apportionment of expenses may result in the effective denial of those deductions if the income is exempt or if the taxpayer is in a permanent excess credit position. If Congress intends that these deductions be available, then it is appropriate to reconsider the expense allocation rules. This may be especially important in the context of research and experimentation given that the Congress clearly wants to create incentives to perform high-value activities in the United States. We make some preliminary comments on these issues below.

Although USCIB is commenting on the proposed regulations, the comment period is very compressed, especially given that the regulations under the Tax Cuts and Jobs Act ("TCJA") interact with each other. Companies will only discover problems as they work with the regulations and apply them to their facts. If the regulations are finalized before problems can be

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[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide and works to facilitate international trade and investment.

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identified, then correcting problems will be more difficult. USCIB is aware that the government would like to meet the 18-month deadline imposed by section 7805(b)(2), nevertheless there should be a mechanism to review these regulations (and other TCJA guidance) to correct for unexpected interactions that create distortive results. One option would be to issue the regulations as temporary regulations with a cross-reference notice of proposed rulemaking. This would both permit the regulations to be retroactive under 7805(b)(2) and allow additional comments to be considered as the regulations move from temporary to final.

Specific Comments

Election for R&E Expense Allocation §1.861-17

As outlined in the preamble, the proposed regulations do not address the existing regulations under §1.861-17 and indicate that a more general review of §1.861-17 will occur later. Under §1.861-17, taxpayers may use either the sales method or gross income method but must use an elected method consistently for five years before changing to another method. For tax years beginning after December 31, 2017, proposed regulation §1.861-17(e)(3) provides taxpayers a one-time ability to change apportionment method without regard to the five-year restriction. However, this one-time change of method constitutes a binding election to use the chosen method for a five-year period.

As taxpayers work to comply with the new system as well as existing and potential future changes to §1.861-17, we request that consideration be given to permitting taxpayers to choose between the sales method or the gross income method annually. With many of the relevant regulations being in a proposed status, providing a non-binding election will better enable taxpayers to understand and comply with the new system, and better assess the impact of the election in light of the many changes to the foreign tax credit rules, the introduction of section 250, and other relevant changes. A more limited alternative that would also be helpful would be to permit the taxpayer to make another election for tax years beginning after December 31, 2018, which would then be binding for five years.

Transition Period 1.250-1(b)

Proposed regulation §1.250-1(b) proposes a transition period that allows taxpayers to demonstrate that property or services have been provided to a foreign person for foreign use using "any reasonable documentation maintained in the ordinary course of business". This type of approach allows a taxpayer to use existing business documents (e.g., commercial invoices, purchase orders, packing slips, bills of lading, etc.) without the creation of unnecessary recordkeeping. The transition period only applies for taxable years beginning on or before March 4, 2019, the period of time up to when the regulations were published. USCIB strongly supports providing a transition period for satisfying the documentation requirements.

As a preliminary matter, the transition rule only applies if the documentation satisfies the reliability requirements described in §1.250(b)-3(d). For taxpayers with contract cycles longer than one year, the available documentation may be more than one year old and therefore may not qualify for transition relief. As discussed below, USCIB believes this standard is too strict even with respect to the final rule, but it certainly should be eased for purposes of the transition period.

USCIB recommends that the government consider making the transition rule permanent to minimize discord with customers and costs to modify existing contract and billing processes as discussed further below. Alternatively, USCIB recommends extending the transition period for the documentation rules. Such an extension would allow the IRS and taxpayers to gain experience with the rules and to determine the extent to which, such rules prove deficient or problematic in practice. Identifying and potentially implementing new documentation requirements will take time, particularly for business models with longer-term contracts; lengthening the transition period to at least five years would provide greater certainty in the near term, accommodate different business models and ease the ability to get new compliance systems or contract provisions in place if necessary. Providing a longer transition period would allow taxpayers a sufficient amount of time to develop and improve internal administrative systems as well as enhance the stability of the new system.

<u>Documentation Requirements §§1.250(b)-3(d)(3), 1.250(b)-4(c)(2), 1.250(b)-4(d)(3), 1.250(b)-4(e)(3), 1.250(b)-5(d)(3), 1.250(b)-5(e)(3)</u>

Following the transition period described above, taxpayers are required to create and maintain additional documentation that may not be necessary and may be difficult, if not impossible, to acquire in the ordinary course of business.

Documentation of status as a foreign person - individuals

Once the transition period has expired, there are only two mechanisms for proving that an individual is a foreign person.[2] A taxpayer making a sale or providing a service to an individual would have to have either: a written statement that the recipient is a foreign person or a valid form of identification issued by a foreign government or agency. This documentation would have to be renewed annually. Taxpayer's engaging with individuals are unlikely to be able to get this documentation, even if the sales do not qualify as small sales. Individuals are highly reluctant to provide these kinds of documents. Adding documentation requirements to sales will have an impact on the ability to conclude sales; individuals will turn to providers that do not make what they perceive to be unnecessary and intrusive requests. In attempting to collect and retain this information, taxpayers may run into conflicts with local jurisdiction privacy laws.

USCIB encourages the government to look to VAT principles for determining what documentation is appropriate. While the FDII deduction is obviously not a transactional tax and, therefore the concerns raised by the documentation requirements are somewhat different than those raised

[2] Assuming that the taxpayer is not entitled to rely on the small business or small transaction exceptions and the Secretary has not provided other options in forms, instructions or other guidance.

by the VAT, many of the companies attempting to comply with these documentation requirements will also be complying with VAT documentation requirements with respect to the same transactions. Therefore, allowing companies to use the same documentation to prove essentially the same thing – the destination of ultimate use of the good in question – would simplify compliance without, USCIB believes, creating an opportunity for abuse.

The OECD's 2015 International OECD VAT/GST Guidelines provide:

> In the business-to-consumer context, jurisdictions are encouraged to permit suppliers to rely, as much as possible, on information they routinely collect from their customers in the course of their normal business activity, as long as such information provides reasonably reliable evidence of the place of usual residence of their customers.[3]

While companies do not collect either a written statement or a valid non-US form of identification, in the case of sales of goods, they do collect some or all of the following: a billing address, a shipping address, an export manifest, a credit card jurisdiction, and a bank account jurisdiction.

For VAT purposes, the EU permits sellers in some cases to rely on two consistent pieces of information that point to the same place of residence. USCIB recommends a similar approach for purposes of section 250. Thus, a billing address and a bank account jurisdiction would be sufficient to support the consumer's status as a foreign person.

Documentation of status as a foreign person – entities

Once the transition period has expired, there are only three mechanisms for proving that an entity is a foreign person.[4] These mechanisms are: a written statement by the recipient that the recipient is a foreign person; documentation that establishes that the entity is organized or created under the laws of a foreign jurisdiction; or documents filed with a government that provide the foreign jurisdiction or residence of an entity. This documentation would also need to be renewed annually.

Like the documentation required to be obtained in the case of individuals, this documentation is extremely unlikely to be provided in the ordinary course of business and foreign businesses are unlikely to be willing to provide it. The regulations should not require these forms of documentation. The documentation that taxpayers collect on businesses is similar to that collected with respect to individuals and may include: a billing address, a shipping address, an export manifest, a credit card jurisdiction, a bank account jurisdiction, a VAT number, commercial invoices, packaging slips, purchase orders, or bills of lading.

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[3] OECD International VAT/GST Guidelines (hereinafter "VAT Guidelines), November 2015, paragraph 3.126.

[4] Again, assuming the exceptions for small businesses and small transactions do not apply and the Secretary has not provided other options in forms, instructions or other guidance.

Presumption of foreign status

If a taxpayer acquires two consistent pieces of documentation (as described above) that indicate foreign status, then the taxpayer should be able to presume that the recipient is a foreign person, unless the taxpayer knows or has reason to know that the documentation is incorrect or unreliable. Allowing the taxpayer to rely on ordinary course documentation, unless the taxpayer knows or has reason to know that it is false will expedite trade and is unlikely to result in significant numbers of false claims of foreign status.

The benefit of the section 250 deduction does not flow to the recipient of the good or service, so the foreign person does not have an incentive to falsify its status. Arguably, even if a recipient were interested in falsifying its status, it would be easier to do so with a false statement than with a foreign bank account or shipping address. Indeed, a statement of foreign status provided by a recipient whose other indicia indicated US status (a US bank account and shipping address) would probably create reason to know that the statement was incorrect or unreliable. If the other indicia are more reliable than the statements, then taxpayers should be able to rely on those indicia in the first instance and not be required to obtain these statements.

Need to renew

Proposed regulation §1.250(b)-3(d)(3) requires that documentation be obtained no earlier than one year before the date of sale or service. This is an unreasonably short period of time, especially if the government retains the current rules with respect to documenting foreign status. Residence status does not change routinely. The regulations under section 1441[5] generally provide a three-year period of validity for withholding certificates. The validity period for purposes of section 250 should not be any shorter than that.

Documentation of foreign use of general property

Like the documentation of foreign status, the documentation required by the proposed regulations[6] for determining foreign use is not documentation that would be obtained in the ordinary course of a trade or business and is likely to be unattainable.

As drafted the recipient of the property would need to provide a written statement or include in a binding contract that the property is intended for foreign use. Based on the definition of foreign use this means that property is not subject to any use, consumption or disposition within the US within three years from delivery. Alternatively, recipients could represent that the property is

[5] Treasury regulation §1.1441-1(e)(4)(ii)(A).
[6] Proposed regulation §1.250(b)-4(d)(3).

subject to foreign manufacture or processing before US use. Recipients may be unwilling to make these representations, even if they do not anticipate using the property within the US.

These representations do not vary depending on whether the customer is a business customer or an individual customer. Individuals purchasing for their own consumption should not be required to make any representations as to foreign use. If it is established that a foreign individual is purchasing a consumer good, that should be sufficient to establish foreign use.

Supply chains are complex. Supply chain information is also sensitive business information. Foreign business recipients may be unwilling to disclose information about their manufacturing processes, even if they have the information available. The 20 percent test of proposed regulation §1.250(b)-4(d)(2)(iii)(C) may be extremely difficult to apply because it may require tracking of fungible parts from different suppliers into a second product. The recipient may not track this information currently and would be required to set up systems to do so in order for an unrelated third party to claim a tax benefit. The recipient of the general property may be unwilling to track this information when there is no benefit to it.

The regulations on foreign use appear to be based on regulations under subpart F and section 199. These regulations were designed to apply to transactions involving related persons or controlled foreign corporations. Thus, information would likely to be available to determine where the manufactured or processed. As illustrated above, it will be much harder for taxpayers to obtain this information from unrelated persons.

USCIB recommends adopting a rule, similar to regulations under subpart F relating to foreign base company sales.[7] Under the subpart F rule, property sold to an unrelated foreign person is presumed to have been sold for use, consumption or disposition in the country of the destination of the property. If the sale is to a related party, then the presumption is reversed. In that case, the taxpayer must prove the place of consumption if it wishes to avoid a subpart F inclusion with respect to the sale. If a similar rule were adopted under section 250, taxpayers be entitled to rely on a presumption of foreign use if the property is sold to a foreign unrelated person and the destination of the property is outside the US. This presumption would not be applicable if the taxpayer knows or has reason to know that the property is "round-trip" property. This standard would be similar to standards adopted in other contexts.[8]

USCIB believes that a presumption of foreign use is appropriate because of the difficulty of looking through a transaction with an unrelated party. Section 250 (b)(4)(i) excludes all sales to US persons, regardless of whether the property is for foreign use. This is an absolute rule, not a presumption. A presumption of foreign use when the sale is to an unrelated foreign person

[7] Treasury Regulation §1.954-3(a)(3)(ii).

[8] See Treas. Reg. § 1.864-6(b)(3)(ii)(a); Treas. Reg. § 1.971-1(b)(1)(i); Treas. Reg. § 1.956-2(b)(1)(iv).

would provide some measure of reciprocity and would still not allow round tripping. The government could also limit such a presumption based on the amount of the sale, although the $5000 threshold of the proposed regulations is much too low to provide any benefits with respect to business-to-business transactions, which would be the only cases when round-tripping is a potential concern.

Three-year rule for foreign use

The documentation requirements refer to the definition of foreign use, so that the statement required under §1.250(b)-4(d)(3) would need to claim that the property is not subject to domestic use within three years of the date of delivery. This is not a reasonable requirement, would be impossible to track on a sale to an unrelated party, and could result in multiple amended returns with the attendant problems discussed below.

Documentation for general services provided to business recipients

Like the documentation of foreign status, and the documentation of foreign use for general property, the documentation for general services provided to business recipients is not documentation that would be obtained in the ordinary course of a trade or business and is likely to be unattainable.

Proposed regulation §1.250(b)-5(e)(3) requires that the documentation for general services provided to business recipients must meet a second requirement: the renderer must obtain information regarding the specific locations of the operations of the business recipient and determine how to allocate the benefit among such locations. Customers will reject requests to provide information on the allocation of benefits among business operations, which is likely considered highly sensitive business intelligence. Foreign entities may also be concerned with long term storage of such information by the renderer as well as the render handing over such information to others including foreign government entities, as would be required to use the information to validate the renderer's deduction on audit.

It may be that Treasury is concerned with abusive situations where a renderer could try to negotiate a discount with a customer in exchange for the customer directly contracting with the renderer through a foreign affiliate. One example may be an advisory contract signed by a foreign parent where the scoped work specifically is to perform analysis of the domestic subsidiary's operations. Abusive behavior related to such negotiated contracts could be more appropriately targeted through a knowledge requirement. Treasury could also consider including such an abusive scenario as an example in the regulations to demonstrate that the taxpayer has actual knowledge of a U.S. benefit that would preclude claiming an FDII benefit.

It might also be reasonable to adopt a presumption similar to that suggested above for general use property. Services should be presumed to benefit a foreign person if the business entity that enters into the applicable business agreement with the renderer establishes foreign status as discussed above. The presumption would be rebutted if the renderer knows or has reason to know that the service benefits a U.S. person. Thus, reasonable documentation obtained in the ordinary course to establish foreign status (e.g., billing address and bank account location), as discussed above, should be acceptable to establish that such foreign-located person is also properly the beneficiary of the service. A reasonable documentation rule, bolstered with the knowledge requirement, would better balance fulfilling Congress's intent of providing a benefit for rendering services within the United States while limiting opportunities for abuse.

Proposed regulation §1.250(b)-5(e)(2)(i)(B) provides rules for determining the amount of a benefit conferred on operations located outside of the United States. Those rules provide that the taxpayer may use any method that is reasonable under the circumstances and reference the principles of §1.482-9(k) concerning the allocation of costs among related parties. The final regulations should make clear that a full-blown 482 analysis cannot be conducted and is not required when the parties are not, in fact, related. The reference to the 482 regulations should be more clearly limited to its principles. A better formulation might be to delete the reference to the 482 regulations and merely include the relevant standards in the final section 250 regulations.[9]

Unless the documentation requirements are substantially revised, excessive documentation may significantly reduce the benefit intended by Congress. Congress also intended to create neutrality between the GILTI deduction and FDII deduction. That neutrality will be significantly eroded unless the documentation requirements are revised. US companies providing technology services from US seller structures will thus be at a disadvantage with respect to companies which organize themselves with foreign selling and IP structures. Thus, US companies would be encouraged to create foreign selling and IP structures in order to ensure that they can claim the full benefit of FDI deduction.

Allowing sellers to use publicly available information to look through to potentially thousands of customers' group structures and territory revenue does little to alleviate the concerns above. Many customers are private companies, including start-ups and other growing businesses. Public sector customers, such as foreign government agencies or NGOs, would also not have public financial statements. Even public companies may likely be filing information as foreign companies on foreign public exchanges, such that segment information may be broken out into e.g., Japanese revenue and "Rest of World" (including US) revenue and may be difficult for US sellers to broadly interpret in any case, due to different standards, formats, or even language. Even for information available in public financial records under US stock exchange rules there is no uniformity in how territories or segments are broken out – the US segment may still be embedded in a North American segment including foreign revenues. Such inquiry would also be extremely impractical from a systems implementation standpoint for renderers, including for those in the technology space or those with millions of customers.

Services Provided to Consumers

[9] Section 1.482-9(k) is only paragraphs long with some examples illustrating the paragraph.

The technology services industry provides an example of the difficulties posed by the proposed regulations. In this industry customers may number in the millions and obtain on demand services through click-through or other fairly standardized agreements that are unlimited by term. Customers that sign up for technology services via click through agreements may be engineers or similar users who would not have access to the business sensitive information that would be required by the proposed regulations. Customers would be forced to delay ordering pending escalations to their finance or legal teams to validate information. This would create tremendous friction in the ordering process and may result in customers seeking other service providers that are not required to comply with these requirements. Additionally, customers might not be comfortable at the time of sign up for on demand services with agreeing that there could never be any benefit for its other affiliates or offices now or in the future as services are consumed and governed by the sign-up terms. This would be further complicated where the seller has tens or hundreds of different service line offerings that are covered by a single agreement framework. These difficulties only address the concerns associated with establishing the initial contract. There would also be significant difficulties associated with setting up internal systems to track and validate the necessary information.

<u>Definition of "Physical and Material Change" Proposed Regulation §1.250(b)-4(d)(2)(iii)(B)</u>

The sale of general property is for a foreign use if the property is subject to manufacture, assembly, or other processing outside the United States. To qualify as manufactured, assembled or processed, general property must be either "subject to a physical and material change," or incorporated into another product as a component. We note that this standard appears to incorporate elements from the standards in the regulations under former section 199 and the regulations under section 954. In each of those contexts, the taxpayer is testing whether activities it conducts itself constitute manufacturing, assembly, or other processing. Under either former section 199 or section 954 the taxpayer will have direct information regarding the extent of physical and material change to property. In the case of section 250, a taxpayer may not know for certain, or be able to demonstrate, the extent of physical or material change to the property being sold to an unrelated party.

To address the first prong test, we recommend the addition of language to further define a "physical and material change." In particular, we recommend that that this test be satisfied where the general property is subject to processing or assembly activities that are substantial in nature and generally considered to constitute the manufacture or production of property that is different than the property which was purchased. This language is similar to the language in the regulations under section 954. This language could be illustrated by the following example.

<u>*Example*</u>: *U.S. Corporation, Corporation A, manufactures computer chips. The chips are sold to an unrelated foreign party, Corporation B, incorporated under the laws of foreign country X. Corporation B manufactures computers, tablets and other computer accessories. Corporation B will incorporate the chips purchased from Corporation A in its manufacturing process. Company B's manufacturing process is substantial in nature and is generally considered to constitute the manufacture or production of computers, tablets and other computer accessories, and not the*

manufacture of computer chips. The chips purchased from Corporation A have been subject to a physical and material change. Thus, they qualify as manufactured, assembled or processed outside the U.S.

Determination of Fair Market Valuation Proposed Regulation §1.250(b)-4(d)(2)(iii)(B)

The sale of general property is for a foreign use if the property is subject to manufacture, assembly, or other processing outside the United States. This test will be satisfied if the property is incorporated into another product as a component. For the second test to be satisfied the fair market value (FMV) of the general property sold must be no more than twenty percent of the FMV of the second product upon completion. For purposes of this rule, the proposed regulations provide that if the taxpayer sells multiple items of property that are incorporated into the second product, then all of the property sold by the seller is treated as a single item of property. We note that this standard appears to incorporate elements from the standards in the regulations under former section 199 and the regulations under section 954. In each of those contexts, the taxpayer is testing whether activities it conducts itself constitute manufacturing, assembly, or other processing. Under either former section 199 or section 954 the taxpayer will have direct information regarding the extent of physical and material change to property. In the case of section 250, a taxpayer may not know for certain, or be able to demonstrate, that this test is met.

As a general rule, for general property sold to an unrelated party, the regulations should incorporate a rebuttable presumption test where general property sold to an unrelated person is presumed to have been sold for use, consumption, or disposition in the country of destination of the property sold unless the taxpayer knows, or has reason to know, that the general property will be used in the United States. We recommend providing a safe harbor or methodology for the determination of the FMV of the completed product. In many cases, a seller of components would have no access to or actual knowledge of which finished product(s) incorporate such components – much less the FMV of such product(s). We recommend that the regulations provide, for example, that a taxpayer who is not able to determine the final product(s) in which the component is used may be able to establish that it qualifies as a component (valued at no more than 20 percent of the ultimate selling price of the finished product) through publicly available data, market research or other similar methods. This language is consistent with the methods to establish foreign use for "fungible mass" in proposed regulation §1.250(b)-4(d)(3)(iii). As it is not feasible that a buyer will share (or even possibly know) this type of information at the time of purchase for certain types of products, a simplified method should be provided in the final regulations.

In addition, in the case of a taxpayer that sells multiple items of property that may be incorporated into products, we recommend providing that the components be treated as separate component items if the seller can establish that a determination of the destination of the component is not feasible based on facts and circumstances. As discussed above, if the seller has no knowledge of which component(s) may be incorporated into the second product(s), it would not be possible to aggregate the components for testing purposes. Moreover, the policy underlying the aggregation rule – to ensure that taxpayers cannot avoid the component rule by disaggregating sales of otherwise integrated components – is not implicated to the extent the taxpayer has no knowledge of which components may be incorporated into which second products.

<u>Example:</u> *Corporation A, incorporated under the laws of the U.S., manufactures and sells computer chips. The chips are shipped to and billed to Corporation B, incorporated under the laws of foreign country X. Corporation B manufactures various types and models of computers that use the chips purchased from Corporation A. Upon the sale of chips to Corporation B, Corporation A has no knowledge of which types or models of computers that Corporation B will manufacture using the chips. The fair market value of the computers could vary greatly by model. However, based on market research or other publicly available data (such as Corporation B's revenue), Corporation A estimates that the chips sold to Corporation B constitute less than 20 percent of the fair market value of the computers into which they are incorporated. Thus, the chips are deemed to be components and qualify as manufactured, assembled or processed outside the U.S.*

<u>Foreign Use for Intangible Property Proposed Regulation §1.250(b)-4(e)</u>

Subparagraph (A) of section 250(b)(5) defines "foreign use" to include "any use …. not within the United States." Proposed regulation §1.250(b)-4(e)(2)(i) provides a sale of intangible property is for a foreign use only to the extent that the intangible property generates revenue from exploitation outside the United States. For intangible property used in the development, manufacture, sale, or distribution of a product, the intangible property is treated as exploited at the location of the end user when the product is sold to the end user.

The rule for foreign use of tangible property is different. The rule for tangible property (referred to as general property) in proposed regulation §1.250(b)-4(d)(2)(i)(B) indicates that property is for foreign use if it is subject to manufacture, assembly, or other processing outside the United States before the property is subject to a domestic use.

The preamble to the proposed regulations asks for comments on whether a rule similar to proposed regulation §1.250(b)-4(d)(2)(i)(B) – the rule that determines foreign use for tangible property – is appropriate for intangible property. As discussed below, USCIB thinks that a similar rule should be adopted. If a licensor grants a licensee the right to make a product outside the US, then the intangible property should be treated as used outside the US.

Sections 250(b)(4)(A) and 250(b)(5)(A) make no distinction between the sale of tangible or intangible property. To qualify as foreign derived deduction eligible income ("FDDEI") the code simply requires the property to be sold to a foreign person for a foreign use, which is defined as as any use, consumption, or disposition that's not within the U.S. Section 250(b)(5)(E) specifies that the terms "sold", "sells" and "sale" shall include any lease, license, exchange, or other disposition of the property.

Although the relevant code sections make no distinction between the sale of tangible property or the sale or license of intangible property, the proposed regulations adopt significantly different rules.

The preamble to the proposed regulation explains the distinction between determining the location of use of intangible property versus general property based on footnote 1522 of the Conference Report of the Tax Cuts and Jobs Act, which provides that "[i]f property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use." The preamble goes on to state "Intangible property is not 'subject to' manufacture, assembly, or processing, and there is no other discussion in the Conference Report that indicates an intent to provide an analogous rule for intangible property otherwise used in the manufacturing process."

USCIB believes that 1) the terminology "subject to" was not meant to distinguish between tangible and intangible property, 2) intangible property is used in manufacturing, assembly or processing, and 3) the Senate report indicates an intent for intangible property used in foreign manufacturing to be considered a foreign use.

The terminology "subject to" was not meant to distinguish between tangible and intangible property

USCIB believes the preamble reliance on the phrasing "subject to" in footnote 1522 of the Conference Report is misplaced. If the Conference Committee wanted to make a distinction between tangible and intangible property, it could have easily done so as illustrated below:

> If *tangible* property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the *tangible* property is subject to manufacture, assembly, or other processing (including the incorporation of such *tangible* property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the *tangible* property is for a foreign use.

If the Conference Committee had intended a distinction to be drawn between tangible and intangible property it would have stated this intent more clearly.

Intangible property is used in foreign manufacturing, assembly or processing should be considered a foreign use

Licenses to intangible property usually include both make and sell rights. For example, a product which requires a patent license to make and sell the product is used outside the US if the product is manufactured outside the US.

The *Senate Explanation* [10] provides the Congressional intent behind section 250.

[10] Senate Committee on the Budget, *Reconciliation Recommendations Pursuant to H. Con. Res. 71*, S. Prt. 115–20 (2017) ("**Senate Explanation**") at 375.

> One of the Committee's goals in tax reform is to remove the tax incentive to locate intangible income abroad and encourage U.S. taxpayers to locate intangible income, and potentially valuable economic activity, in the United States. The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign 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. In addition, the Committee recognizes that many countries in the OECD have preferential tax regimes for income related to certain forms of intellectual property. These regimes, sometimes referred to as patent box or intellectual property regimes, put the United States at a competitive tax disadvantage. The Committee believes that establishing a deduction for foreign derived intangible income earned by domestic corporations helps the United States compete with countries that offer preferential rates for intellectual property.

In order to encourage the movement of intangible income to the US reduce or eliminate the tax incentive to locate or move intangible income abroad and compete with countries that have patent box or intellectual property regimes, the use of tangible or intangible property used in foreign manufacturing should be considered a foreign use.

USCIB believes proposed regulations for the license of intangible property should recognize that there is a foreign use of the intangible property when rights to manufacture are granted to the licensee and the manufacturing takes place outside the US. Therefore, a rule similar to proposed regulation §1.250(b)-4(d)(2)(i)(B) – the rule for tangible property – should be adopted for intangible property.

This treatment conforms with the plain meaning of section 250(b)(5)—a license or sale of intangible property for manufacture or other processing outside the U.S. is **a** use of the intangible property not within the U.S., and thus a "foreign use." In addition, both the sale of tangible and intangible property for use in offshore manufacturing most often leave the seller or licensor in the position of not knowing where the manufactured good is ultimately sold.

Documentation of Foreign Use of Intangible Property Proposed Regulation §1.250(b)-4(e)(3)

USCIB recommends that final regulations recognize foreign use of the intangible property when rights to manufacture are granted to the licensee and the manufacturing takes place outside the US. The documentation requirements would need to change to accommodate this expansion of foreign use based on place of manufacture. For royalties from third parties, if none of the documentation allowed in § 1.250(b)-4(e)(3)(A) to § 1.250(b)-4(e)(3)(E) is available, the regulation should adopt a presumption that a royalty from an unrelated foreign person is for a foreign use unless the taxpayer has reason to know that the licensee's product was manufactured in the US. Where the taxpayer has reason to know that some portion of the licensee's product was manufactured in the US, they should be able to use reasonable methods to estimate the potion of the licensee's product that was manufactured in the US.

Definition of Foreign Branch Income Proposed Regulation §1.250(b)-1(c)(11)

Section 250(b)(3) defines deduction eligible income as the gross income of a domestic corporation in excess of certain excluded amounts. Among the excluded amounts is foreign branch income as defined in section 904(d)(2)(J).[11] Section 904(d)(2)(J) defines foreign branch income as business profits attributable to one or more qualified business units ("QBU"). That section gives authority to the Secretary to determine "the amount of business profits attributable to a qualified business unit". Proposed regulation §1.904-4(f)(2)(iv)(A) specifically excludes from foreign branch income gain from the disposition of a partnership, other pass-through entity or a disregarded entity. This exception is limited under §1.904-4(f)(2)(iv)(B) if the interest is recorded on the books and records of the foreign branch and the interest is held by the foreign branch in the ordinary course of its active trade or business. Thus, the regulations under section 904 completely address the treatment of gain on the disposition pass-throughs and disregarded entities and there does not seem to room for another rule under section 250(b)(3). Nevertheless, the proposed regulations under §1.250(b)-1(c)(11) foreign branch income provide that "**any income or gain that would not be treated as gross income attributable to a foreign branch under §1.904-4(f) but that arises from the direct or indirect sale … 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 interest in a partnership.**"

USCIB believes that the section 904 regulations reach the correct conclusion; income from the sale of branch is not attributable to the branch. Section 250 does not give the Commissioner authority to expand this definition. Rather, it is clear that the definitions are required to be the same. The preamble to proposed regulations does not explain or justify the deviation from the section 904 regulations. USCIB recommends that the final regulations be amended to delete this special rule and follow the section 904 regulations as required by section 250(b).

Amended returns required

The proposed regulations[12] treat a related party sale as a FDDEI sale if a qualifying unrelated party transaction occurs by the FDII filing date. If the unrelated party sale occurs after the FDII filing date, the taxpayer may file an amended return within the period of limitations. Amended returns create an undue burden on the taxpayer as well as administrative burdens on the IRS as a taxpayer may end up filing multiple amended returns for every year. Any time a taxpayer amends a return it is signed under penalties of perjury, which requires the taxpayer to assess all facts filed in the prior year and re-review the entire return to make sure no new information about anything previously filed has been uncovered. In addition, all the state tax returns would need to be amended. This burden should not be imposed simply to claim the FDII benefit.

[11] Section 250(b)(3)(A)(VI).

[12] Proposed Regulation §1.250(b)-6(c)(i)

An alternative would be to allow the U.S. taxpayer to treat the related party sale as an eligible FDDEI transaction in the year it is sold to a related party and calculate the DEI accordingly. If in a subsequent year the property is sold to an unrelated party that does not qualify for foreign use, the DEI of the U.S. taxpayer would be reduced in that subsequent year. Under this proposal recapture could occur at any time. This could be coupled with a statement that based on the available information, the taxpayer reasonably expects the property will be sold to a foreign person for foreign use.

Another less preferred alternative would be to treat the related party sale as an eligible FDDEI transaction in the year of the related party sale. Only if the property is not sold to an unrelated party for foreign use within the statute of limitations would an amended return be required to exclude the transaction as not eligible for FDDEI treatment.

If you have any questions concerning the comment letter or would like to discuss these issues further with USCIB, please contact Carol Doran Klein, cdklein@uscib.org.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)