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May 6, 2019

U.S. Department of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

Internal Revenue Service
1111 Constitution Ave. NW
Washington, DC 20224

Via Online Submission

RE: Proposed Regulations under Section 250

Dear Sir or Madam:

On March 6, 2019, the Internal Revenue Service (the Service) and the U.S. Department of the Treasury (the Treasury) published proposed regulations (the Proposed Regulations)[1] under new section 250,[2] which provides a deduction for domestic corporations with respect to their foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). Section 250 was enacted as part of Public Law 115-97,[3] colloquially known as the "Tax Cuts & Jobs Act" (the Act). The Treasury and Service (collectively, the Government) requested public comments regarding the Proposed Regulations no later than May 6, 2019. On behalf of Tax Executives Institute, Inc. (TEI), I am pleased to respond to the Government's request for comments.

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1 REG-104464-18, 84 Fed. Reg. 8,188 (Mar. 6, 2019).

2 Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the Code) and all "§" references are to the Treasury regulations promulgated thereunder.

3 Act of Dec. 22, 2017, Pub. L. No. 115-97, 131 Stat. 2054.

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TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 57 chapters in North and South America, Europe, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our more than 7,000 individual members represent over 2,800 of the leading companies around the world.

TEI members are responsible for administering the tax affairs of their companies and must contend daily with provisions of the tax law relating to the operation of business enterprises, including the new FDII and GILTI regimes, along with many other aspects of the Act. We believe that the diversity and professional experience of our members enables TEI to bring a balanced and practical perspective to the issues raised by the Proposed Regulations, and we are eager to assist the Government in its critical effort to effectively and efficiently implement the Act.

TEI Comments

Documentation Requirements for Foreign Use

The documentation requirements set forth in Prop. Treas. Reg. §§ 1.250-4(d)(2)(i) "Determination of foreign use," and 1.250-4(d)(2)(ii) "Determination of domestic use," are burdensome and present significant compliance difficulties. For example, the requirements would interfere with the ability of retail businesses to nimbly serve their customers by sourcing small amounts of inventory from locations in close geographic proximity to the United States. More importantly, the documentation the Proposed Regulations require multinational businesses to obtain is not the type of documentation such a business would reasonably expect customers to provide (e.g., foreign identification, whether property incorporated into a second product as a component is "no more than 20 percent of the fair market value of the second product, determined when the second product is completed"[4]). In addition, some of the documentation set forth in the Proposed Regulations is information customers could not reliably provide, or represent as accurate, even if they were willing to provide the information (e.g., a statement that the property is "not subject to a domestic use within three years of the date of delivery"[5]). To present a simple example, a taxpayer may sell goods to a large multinational retailer with an address in one location, and yet ship the goods to an address in another location (such as a regional warehouse), and the retailer may then ship the goods to a customer in a third location. When the retailer purchases the goods in the first step of this chain, it would be difficult if not impossible for the retailer to accurately represent that the goods will never be used in the United States within the next three years.

Similarly, taxpayers who leverage third party retail partners to sell the taxpayers' products often do not have clear insight into the ultimate location in which the product is consumed. Typically, the contracts with third party distributors clearly define sales territories, however, such a requirement does

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4 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(iii)(C).
5 Prop. Treas. Reg. § 1.250(b)-4(d)(2)(i)(A).

not always prevent a third-party retailer from transferring property to another of its sales jurisdictions for compelling business reasons. To ameliorate this issue, the special rules for small business and small transactions outlined in Prop. Treas. Reg. § 1.250(b)-4(d)(3)(ii) should be expanded to apply to larger businesses if small amounts of inventory supplied to a foreign related party are used to satisfy minor U.S. inventory shortfalls.

Regarding the requirements documenting the foreign use of "general property," Prop. Treas. Reg. § 1.250(b)-4(d)(3)(i) states that acceptable documentation establishing such foreign use includes:

> (A) A written statement from the recipient or a related party of the recipient that the recipient's use or intended use of the property is for a foreign use (within the meaning of paragraph (d)(2) of this section);
>
> (B) A binding contract between the seller and the recipient which provides that the recipient's use or intended use of the property is for a foreign use . . . .

As a threshold matter, this regulation appears to require recipients to specifically trace the use of *all* the property it purchases, which includes being able to determine that "[t]he property is not subject to a domestic use within three years of the date of delivery . . . ."[6] In TEI's view, this places an intolerable burden on recipients, especially unrelated recipients, to predict the future use of property the recipient purchases. Moreover, even if the recipient could show that the "intended" use of the property was foreign, if that intention is not in fact ultimately fulfilled it is easily subject to second guessing on audit. Further, it is rare for sellers to ask buyers for documentation or a representation as to the intended "use" of the property sold (as opposed to limiting the locations where property may be re-sold to, such as in the retail context). Hence, recipients are likely to be reluctant to provide such information as a general business matter, whether via written statement or in a binding contract, as it is not something typically provided in the ordinary course of a business transaction. For these reasons, and as we recommend above, TEI suggests that these foreign use documentation requirements be replaced in final regulations with the special rules for small business and small business transactions set forth in Prop. Treas. Reg. § 1.250(b)-4(d)(3)(ii), allowing sellers to treat property as for a foreign use if the "seller's shipping address for the recipient is outside the United States." Potential abuse of this new rule could be policed by the "know or have reason to know that the recipient is not a foreign person or that the property will not be for a foreign use" standard.

If such a change is not acceptable to the Government, to help alleviate concerns of recipients TEI recommends that a de minimis (or safe harbor) exception if the recipient or related party of the recipient provides a written statement that not more than five percent of the foreign use property (in the case of a related party) and not more than ten percent of the foreign use property (in the case of an unrelated third party) would be used in the United States. While such a change might still require some level of "tracing" by the recipient, it would nevertheless encourage third party recipients to provide the required

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6 *Id*.

documentation as they would not need to certify that 100 percent of the property purchased would not be used in the United States.

Separately, with respect to the reliability of documentation, Prop. Treas. Reg. § 1.250(b)-3(d)(3) provides that documentation is only reliable if the "documentation is obtained no earlier than one year before the date of the sale or service." This requirement is impractical for long-term supply contracts or successive short-term contracts with the same supplier, which typically do not necessitate a review of basic documentation each year or for each successive contract. For such long-term and successive contracts, in TEI's view documentation should be considered reliable as long as the as documentation is obtained at the inception of the first contract and the seller or renderer meets the requirements of Prop. Treas. Reg. § 1.250(b)-3(d)(i) regarding knowing or having reason to know that the documentation is unreliable "as of the FDII filing date".

If the Government is not comfortable relying on such an approach, a possible alternative would be to adopt the timeframe for documentation of withholding certificates used to determine foreign status under Treas. Reg. § 1.1441-1(e)(4)(ii). Under those regulations, the certificate is valid until the earlier of the last day of the third calendar year following the year in which the withholding certificate is signed or the date that a change in circumstances occurs that makes any information on the certificate incorrect. Thus, should the Government be uneasy in permitting taxpayers to rely upon the documentation acquired at the inception of a contract, whether a long term contract or successive short term contracts, TEI recommends the final regulations use the language of Treas. Reg. § 1.1441-1(e)(4)(ii) for the limitation on the validity of the documentation, either by cross-reference to that regulation or incorporating the same language into the final section 250 regulations.

<u>Documentation Requirements for Business Services</u>

The Proposed Regulations' approach to business services[7] (the Business Services Provisions) requires service providers to gather information which will be difficult or impossible to obtain. U.S. service providers generally cannot reasonably determine where their customer's operations are located or allocate the benefit of the U.S. providers' services among those operations. Taxpayers cannot do this independently and, in TEI's view, customers will not provide this information. Absent a change to these requirements in the final regulations, U.S. taxpayers will often fail to qualify for FDII benefits for services provided to non-U.S. customers. Such a result would eliminate the parity between FDII and GILTI that section 250 sought to establish and thereby undermine the statutory scheme underlying the TCJA's international provisions. Thus, TEI believes that the Government should replace or supplement the Business Services Provisions with workable rules for business services using documentation businesses currently collect while safeguarding against potential abuses.

The Proposed Regulations require U.S. service providers to establish that their services benefit their customer's operations outside the United States. In effect, a service provider must determine where

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7 *See* Proposed Treas. Reg. § 1.250(b)-5(e).

its customers maintain an "office or other fixed place of business,"[8] then reasonably allocate the benefit of the taxpayer's service among those operations. Each of these determinations must be supported with documentation that "specifies" or "establishes" the location of the customer's operations.[9]

It will be extremely difficult for U.S. service providers to obtain the documentation contemplated by the Business Services Provisions for many reasons. First, customers have no incentive to provide the information required by these regulatory provisions. This stands in sharp contrast to U.S. withholding rules under sections 1441 and 1471, which use the threat of withholding to force payees to provide the appropriate tax forms. Second, customers often have not determined, or even considered, where the benefits of a particular service should be allocated among their operations. Third, even if customers have made such a determination, the resulting analysis would be considered proprietary business information that cannot or will not be shared with a potential competitor or with a vendor who might use it for price negotiation or other competitive purposes. Lastly, even if a customer did share this sensitive data, the U.S. taxpayer would then possess proprietary business information on its systems, information that would be subject to significant liability risk in data breaches. For these reasons, the documentation requirements of the Business Service Provisions are impractical.

In addition, in TEI's view permitting taxpayers to rely on publicly available information to satisfy the Business Services Provisions is not a workable solution. Such information is generally available only when the customer is publicly-traded on a U.S. stock exchange. Most businesses (including many large businesses) are privately held, and therefore are not subject to shareholder disclosure rules. Further, even publicly-traded corporations (particularly those headquartered outside of the United States) often do not break out financial and other information between the United States and the rest of the world. Finally, combing through the annual reports of the subset of customers who provide meaningful information in such reports will impose substantial compliance burdens on large U.S. taxpayers who may provide services to hundreds (or even thousands) of publicly-traded corporations each year.

More broadly, documentation requirements for services that substantially reduce or eliminate the ability to claim a section 250 deduction are contrary to the policy underlying that provision. As noted in the preamble, the objective of section 250 is "to help neutralize the role that tax considerations play when a domestic corporation chooses . . . whether to earn [intangible income attributable to foreign-market activity] through its U.S.-based operations or through its CFCs."[10] As constructed, the Business Services Provisions inevitably push well-advised U.S. taxpayers towards earning intangible income through their CFCs, because the resulting GILTI will qualify for a lower U.S. effective tax rate without imposing a such a documentation burden.

For these reasons, TEI recommends the final section 250 regulations permit taxpayers to determine the FDII status of service income based on information already collected by U.S. service

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8 Proposed Treas. Reg, § 1.250(b)-5(e)(2)(ii).
9 Proposed Treas. Reg. § 1.250(b)-5(e)(3)(i) and -5(e)(3)(i)(A).
10 84 Fed. Reg. 8,189 (Mar. 6, 2019).

providers in the ordinary course of business – namely, a customer's billing address, tax ID number, primary contact name and address, or the location of a credit card issuer or bank. The EU VAT rules applicable to electronically supplied services, for instance, determine the location of a service based on two non-conflicting pieces of customer information. Many U.S. service providers are already subject to these rules and thus have developed the necessary systems to collect the required documentation.

TEI acknowledges that some customers may provide the documentation recommended above but then internally transfer services to U.S. affiliates. At the same time, in certain cases a U.S. service recipient may internally transfer a service benefit to foreign affiliates. While the Business Services Provisions (and the Proposed Regulations generally) would ideally uncover the ultimate end-user of a service, TEI believes this is practically impossible for business services transactions. We believe the issue of internal transfers by service recipients can be best resolved by Treasury requiring taxpayers to apply a consistent methodology to determine the location of general business services, which would prevent "cherry-picking" among customers.

We understand that the Government may be concerned with artificial transactions where a non-U.S. entity purchases services on behalf of a U.S. affiliate to increase the service provider's FDII benefit. However, there will normally be no economic incentive for a customer to change its behavior for the sole benefit of the service provider. Moreover, accommodation arrangements where the customer changes their purchasing arrangements in exchange for preferential pricing should be captured by the "reason to know" rules currently in the Proposed Regulations.

Delayed Documentation Requirement Applicability Date

Regardless of the design of the documentation requirements in the final section 250 regulations, the proposed applicability date of the regulations[11] is far too soon. Given the necessary lead time for taxpayers to develop the systems to collect any information that is not already collected in the ordinary course of a taxpayer's trade of business, TEI recommends delaying the applicability date of the final documentation requirements to taxable years beginning on or after one year from the date the final regulations are published (i.e., if final regulations are published on June 15, 2019, taxpayers would only need to comply with the documentation requirements in taxable years beginning on or after June 15, 2020).

Cost of Goods Sold under Prop. Reg. § 1.250(b)-1(d)(1)

Prop. Reg. § 1.250(b)-1(d)(1) provides that "[c]ost of goods sold must be attributed to gross receipts with respect to gross [deduction eligible income] DEI or gross [foreign-derived deduction eligible income] FDDEI regardless of whether certain costs included in cost of goods sold can be associated with activities undertaken in an earlier taxable year (including a year before the effective date of section 250)." The requirement to consider cost of goods sold related to income recognized before the

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11 The Proposed Regulations state they "apply to taxable years ending on or after March 4, 2019." Prop. Treas. Reg. § 1.250-1(b).

enactment of section 250 is unobjectionable. However, for future periods TEI recommends that the Government provide an election for advance payments that are recognized as revenue under the requirements of section 451. In particular, TEI recommends that taxpayers have the elective ability to create an imputed a cost of goods sold deduction based upon its gross profit percentage for that particular product or service. This would only impact the FDII deduction and not taxable income.

Such an election is needed because recognition of an advance payment as income without associated cost of goods sold might be required under section 451 based upon certain facts and circumstances. The requested election would allow the taxpayer to avoid the distortive impact that a lack of a cost of goods sold reduction may have on the FDII deduction both in the year of receipt of the advance payment and in the year that the goods are delivered. In the year of delivery, when the actual cost of the goods is deducted, this deduction would be included in the FDII calculation along with the reversal of the imputed cost included in the year of receipt.

As an example, assume in Year 1 that the taxpayer received an advance payment of 500 that meets the requirements of FDDEI and that its average gross profit margin is 25% meaning that its COGS percentage would be 75%. Under the proposed election, the taxpayer could elect to include a hypothetical deduction of 350 in calculating it's FDII deduction. Assume that the goods are delivered to the customer in Year 2 and that the actual cost of goods sold related to these items is 380. The imputed deduction for Year 1 would be reversed in Year 2 leaving a reduction of 30 in COGS in Year 2 for purposes of calculating the FDII deduction.

<u>Reinstating exclusive apportionment rules for purposes of the FDII deduction</u>

The allocation and apportionment rules applicable to research and experimental expenditures under Treas. Reg. § 1.861-17 are intended to incentivize research and development (R&D) activities performed in the United States. Prop. Treas. Reg. § 1.250(b)-1(d)(2) provides that the exclusive apportionment rules in Treas. Reg. § 1.861–17(b) do not apply for purposes of apportioning research and experimental expenditures to gross DEI and gross FDDEI. This rule creates a significant disincentive to taxpayers seeking to onshore their intellectual property (IP) and works against Congress's intention to encourage businesses to perform R&D activity and hold intellectual property in the United States.

The final regulations should support the intent of Congress by reestablishing the principles under Treas. Reg. § 1.861–17(b) for purposes of apportioning R&D to gross DEI and FDDEI. Additionally, the final regulations should provide that the provisions of Treas. Reg. § 1.861-17(c)(3) that require sales to third parties by controlled foreign affiliates to be included should not be required for this purpose as it artificially apportions more R&D expense against FDDEI. Licensing or sales of intangible property are considered to be a sale under section 250 and accordingly only the actual revenue derived from such licensing or sale should considered in apportioning research expenditures between FDDEI and non-FDDEI.

Tracking exploitation of manufacturing and supply chain related intellectual property to the place of manufacture as opposed to the end user

For property sales, the Proposed Regulations trace the exploitation of intellectual (or intangible) property (IP) solely by reference to the end user of the end user.[12] However, in TEI's view, this approach does not properly source manufacturing and supply chain related IP to where it is actually used and appropriately traced.

In our view, manufacturing and supply chain IP are used to perform services by a foreign party if they are exploited outside the United States by manufacturers to source raw materials and product. Supply chain IP is therefore consumed to the benefit the manufacturer – not the end user – and should be traced to the manufacturing location. This view is consistent with the regulations regarding proximate services in Prop. Treas. Reg. § 1.250(b)–5, where the regulations view services as foreign use when they are performed in connection with the physical transformation of property, occur in proximity to the property, and the property remains outside the United States while the services are performed.

Thus, the final section 250 regulations should provide that the exploitation of manufacturing and supply chain IP is a foreign used service, consumed at the place of manufacture, if it meets the physical transformation and proximity requirements outlined in the regulations.

The "Property Services" Rule

Prop. Treas. Reg. § 1.250(b)-5(g) provides that a property service is provided with respect to tangible property located outside the United States "only if the property is located outside the United States for the duration of the period the service is performed." This rule effectively requires most, if not all, of the actual servicing of the property to take place outside the United States. In TEI's view, this approach contradicts one of the primary intentions behind the TCJA, which was to "on-shore" commercial activities and encourage U.S. job growth.

Section 250(b)(4)(B) defines FDDEI, with respect to services, as "services provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are not provided to any person, or with respect to property, not located within the United States." This section clearly indicates an "OR" test – either the services are provided to a person not located within the United States, or the services are provided with respect to property not located within the United States. For the service to be eligible under these criteria, only one test need be met using the "or" conjunction. By implementing a prescribed ordering system to classify services under the proposed regulations, Treasury removes the "or" test established by Congress, frustrating its clear intent. By disallowing FDDEI eligibility to services performed upon property within the United States, the Government only affords this benefit to imports of foreign property services, which is contrary to the intention of the legislation. The final regulations

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12 *See* Prop. Treas. Reg. § 1.250-4(b)(e)(2)(i) ("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.").

should allow for the use of the general services category if the prescribed service recipient condition is met according to the Code.

To better effectuate this purpose, TEI recommends that instead of using the location of the serviced property, it would be better to base the rule on the ownership of the serviced property. For instance, in a repair and maintenance scenario, if the owner of the property is foreign for the duration of the service, the service should be considered DEI regardless of whether the service was performed in the United States. This would better effectuate the TCJA's purpose of encouraging economic activity in the United States.

Clarification of ordering rule for charitable contributions

The Proposed Regulations' preamble notes that many code provisions limit the availability of a deduction based, directly or indirectly, upon a taxpayer's taxable income.[13] These provisions include the section 163(j)(1) limitation on business interest as well as the section 172(a)(2) limitation on net operating loss deductions. Neither section 163(j) nor section 250 provide an ordering rule with respect to the other provision, and thus the Proposed Regulations provide such a rule requiring the taxable income limitation of section 250(a)(2) to be determined after all the corporation's other deductions are taken into account.[14] However, not referenced in the Proposed Regulations is the limitation on charitable contributions, which is also determined by reference to a taxpayer's taxable income. TEI recommends that final regulations clarify where the charitable contribution deduction limitation fits in the ordering rule, along with sections 163(j), 172, and 250.

Impact of pending court cases related to pre-TCJA years on the FDII deduction

The *Altera* case regarding the section 482 stock-based compensation cost-sharing regulations is currently awaiting a (second) opinion from the United States Court of Appeals for the Ninth Circuit. Should the Ninth Circuit rule in favor of Altera, charge outs by a U.S. controlled cost-sharing participant to a non-U.S. controlled participant regarding stock compensation expense for the years prior to the enactment of the TCJA will have to be reimbursed to the non-U.S. controlled participant.

The final section 250 regulations should be explicit that such reimbursements by the U.S. controlled participant to the non-U.S. participant are not to be allocated against FDDEI generated during the year that the reimbursements are made.

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TEI appreciates the opportunity to comment on the Proposed Regulations. TEI's comments were prepared jointly under the aegises of the Institute's Tax Reform Task Force and U.S. International Tax Committee. Should you have any questions regarding TEI's comments, please contact the Task Force's

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13 84 Fed. Reg. 8,189 (Mar. 6, 2019).

14 *See* Prop. Treas. Reg. § 1.250(a)-1(c)(4).

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Respectfully submitted,
TAX EXECUTIVES INSTITUTE

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