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That's Foreign to Me: FDII's Final Rules on Partnerships[1]

The below discussion summarizes recent Treasury guidance and highlights three areas that partnerships should focus their attention with respect to cross-border sales and services transactions under the new foreign-derived intangible income (FDII) regime: the treatment of partnerships as aggregates of their partners or distinct entities, related party transactions, and reporting requirements.

BACKGROUND

The 2017 Tax Cuts and Jobs Act added Code Section 250,[2] which generally allows a domestic corporation to claim an annual 37.5% deduction of its FDII and a 50% deduction of the sum of its global intangible low-taxed income inclusion and associated Section 78 gross-up.[3]

The Section 250 deduction is available only to domestic corporations. Partnerships, however, are implicated in the FDII regime. The statute left open several questions, including whether a domestic corporate partner of a partnership is permitted to deduct its share of the partnership's FDII, whether FDII is computed at the partner or partnership level, and specific reporting requirements of partnerships with FDII items. Proposed regulations (REG-104464-18, 84 F.R. 8188), published on March 6, 2019, addressed these partnership-related questions. Final regulations (T.D. 9901), published on July 15, 2020, retained the partnership provisions provided in the proposed regulations while also making some clarifications.

FDII AND PARTNERSHIPS

As explained below, the proposed regulations and final regulations adopted a hybrid approach to partnerships, treating them as aggregates and entities for separate purposes; both sets of regulations provide that partnerships engaging in related party transactions with certain controlled foreign corporations can be excluded from FDII; and the proposed regulations provided for specific reporting requirements while the final regulations modified and clarified such provisions.

Distributive Shares of FDII

The proposed regulations adopted an aggregate approach for purposes of determining a corporate partner's FDII attributable to the income of a partnership. The proposed regulations provided that a domestic corporate partner takes into account its distributive share of a partnership's gross deduction eligible income (DEI), gross foreign-derived deduction eligible income (FDDEI), and deductions of any partnership (whether domestic or foreign) in which the corporation is a direct or indirect partner. The final regulations retained this aggregate approach with respect to a corporate partner's distributive share of a partnership's FDII.

The proposed regulations simultaneously adopted an entity approach for purposes of determining whether sales to or by a partnership and services to the partnership are

considered FDDEI transactions – a component of the FDII calculation. For these purposes, the proposed regulations relied on a partnership being treated as a "person" pursuant to Section 7701(a)(1). Thus, for example, a sale of property to a foreign partnership for a foreign use may constitute a FDDEI sale because such sale is to a foreign person, whereas a sale of property to a domestic partnership, even if for foreign use, will not constitute a FDDEI sale because such sale is to a domestic person. The final regulations retained this entity approach.

Related Party Transactions and Modified Affiliated Group

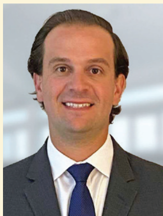
Generally, a related party sale or provision of service may qualify as a FDDEI transaction. Sales of "general property" and provisions of "general services," (as such terms are defined in the final regulations) however, must satisfy additional requirements to qualify as FDDEI transactions. The proposed regulations define a related party with respect to any person as any member of a "modified affiliated group" that includes such person. A "modified affiliated group" means an affiliated group as defined in Section 1504(a) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to Sections 1504(b)(2) and (3). The final regulations retained this definition.

Partnerships can be treated as members of a modified affiliated group. Both the proposed and final regulations contain an example of a sale by a partnership to a foreign related party not qualifying as a FDDEI transaction. The example provides that a domestic corporation (DC) owns 25% of the capital and profits of partnership (PRS), which in turn owns 100% of the single class of a foreign corporation (FC). During the taxable year, PRS has a $20 gain on the sale of general property to FC, and FC makes a material physical change to the property outside the United States before selling the property to customers in the United States. The example concludes that PRS's sale of general property to FC is a related party sale because FC and PRS are members of a modified affiliated group within the meaning of the rules. Because FC did not sell the property or use the property in connection with other property sold or the provision of a service to a foreign unrelated party before the property was subject to domestic use, the sale by PRS to FC does not qualify as a FDDEI transaction.

Reporting

The proposed regulations provided that a partnership that has one or more direct or indirect domestic corporate partners and that is required to file a return under Section 6031 (*i.e.*, a domestic partnership as defined in Section 761(a) or a foreign partnership that derives gross income from sources within the United States or that that has income effectively connected with a U.S. trade or business) must furnish to each partner on or with such partner's Form 1065 (Schedule K-1) the partner's share of the partnership's gross DEI, gross FDDEI, deductions that are definitely related to the partnership's gross DEI and gross FDDEI, and partnership qualified business asset investment (QBAI) for each taxable year that the partnership has these items or partnership specified tangible property.

The final regulations retained the proposed regulations' reporting rule and clarified reporting requirements for partnerships in tiered-partnership situations. The final regulations provide that in the case of tiered-partnerships where one or more partners of an upper-tier partnership (UTP) are domestic corporations, a lower-tier partnership (LTP) must report to the UTP its share of LTP gross DEI, gross FDDEI, deductions that are definitely related to the partnership's gross DEI and gross FDDEI, and partnership QBAI for each taxable year that the LTP has these items or LTP specified tangible property; this allows for reporting of such information to any UTP domestic corporate partner. If a partnership cannot determine the information described above, the partnership must instead furnish to each partner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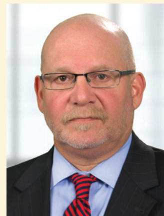
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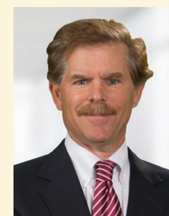
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(including UTPs) its share of the partnership's attributes that a partner needs to determine the partner's gross DEI, gross FDDEI, deductions that are properly allocable to the partner's gross DEI and gross FDDEI, and the partner's adjusted bases in partnership specified tangible property.

STRADLEY RONON'S OBSERVATIONS

Although FDII applies only to domestic corporations, partnerships with domestic corporate partners must be aware of special FDII rules applicable to partnerships. A partnership (domestic or foreign) determines whether it entered into FDII transactions during the taxable year at the entity level, while domestic corporate partners calculate their FDII deduction based on their distributable share of FDII items. Moreover, partnerships should be aware of their relationships with foreign service providers or purchasers. Specific rules for related parties and modified affiliate groups can affect the eligibility of partnership transactions to qualify as a FDII transaction. Partnerships with FDII items during the taxable year must share information with their domestic corporate partners to enable such partners to calculate their respective FDII deductions. Similarly, LTPs must provide information to UTPs to enable the ultimate domestic corporate partners of such UTPs to calculate their respective FDII deductions. Under FDII, cross-border sales and services may be foreign for one partnership but not for another. Even if the FDII rules can seem "foreign to me," a partnership's determination of whether any of its income resulting from sales and services is "foreign to me" can be a valuable endeavor.

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[1] This update is part of an occasional series supplementing Stradley Ronon's weekly Tax Insights.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code).

[3] A domestic corporation's inclusion of a controlled foreign corporation's subpart F income is not eligible for the Section 250 deduction and is therefore generally subject to U.S. tax at the full corporate rate.

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