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The Proposed FDII Regulations: Foreign Use of IP

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Income earned by a U.S. corporation from licensing intangible property generally is subject to a 21% tax rate. However, a 13.125% effective tax rate applies to royalty income earned from a foreign person for the use of intangible property outside the United States.¹ Such income is referred to as foreign derived intangible income (FDII).²

For royalty income to be eligible for the lower rate, a U.S. corporation must establish that the intangible property is for “use” that is “outside the United States” by a foreign licensee. Such income is referred to as foreign-derived deductible eligible income (FDDEI).³ Recently issued proposed regulations provide

rules for determining when royalties are considered to be FDDEI.⁴

The proposed regulations provide that royalties are considered as received for foreign use of intangible property to the extent that the intangible property generates revenue from exploitation of the intangible property outside the United States.⁵ Royalties received for exploitation both within and outside the United States are for a foreign use in proportion to the revenue generated from exploitation of the intangible property outside the United States over total revenue generated from exploitation of the intangible property.⁶

The regulations require a U.S. corporation to have reliable documentation of foreign use for royalties to qualify as FDDEI.⁷ Such documentation can include written statements from the licensee providing the amount of annual revenue from sales or sublicenses of the intangible property, or sales of products with respect to which the intangible property is used that are generated as a result of exploitation of the intangible property outside the United States and the total amount of revenue from such sales or sublicenses

¹ §250(a)(1)(A). The lower rate also is available for certain foreign-derived income from selling intangible property, leasing or selling tangible property, and providing services. §250(b)(4), §250(b)(5)(E).

All section references are to the Internal Revenue Code, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

² The 13.125% tax rate applies to gross FDII reduced by deductions allocated and apportioned to the FDII, and further reduced by 10% of the aggregate basis in depreciable tangible property that gives rise to the FDII. §250(a)(1)(A), §250(b)(1), §250(b)(2), §250(b)(3).

³ §250(b)(4)(A)(ii), §250(b)(5)(A); Prop. Reg. §1.250(b)-4(c)(2). The licensee must be a foreign person, who can be related or unrelated to the taxpayer, and the taxpayer must satisfy certain documentation requirements. §250(d)(4)(A); Prop. Reg. §1.250(b)-4(b), Prop. Reg. §1.250(b)-4(c). For this purpose, members of a U.S. consolidated group are treated as divisions of a single taxpayer. See Reg. §1.1502-13; Prop. Reg. §1.1502-13(c)(7)(ii)(T) Ex. 20.

⁴ REG-104464-18, 84 Fed. Reg. 8188 (Mar. 6, 2019). The proposed regulations are generally effective for tax years beginning on or after March 4, 2019, but taxpayers are permitted to rely on the proposed regulations for tax years beginning before that date. Prop. Reg. §1.250-1(b). The proposed regulations use the word “sale” to refer to a license or sale of intangible property. This language follows from the definition of a “sale” for purposes of the FDII rules as including a license of intangible property. §250(b)(5)(E); Prop. Reg. §1.250(b)-4(b).

⁵ Prop. Reg. §1.250(b)-4(e)(2). The Code defines foreign use as “any use, consumption, or disposition which is not within the United States.” §250(b)(5)(A).

⁶ In determining foreign use, the proposed regulations do not adopt the rules for determining whether a royalty is foreign-source or U.S.-source income. See Yoder, *Royalties Qualifying for FDII*, 44 Int'l Tax J. 3 (Sept.–Oct. 2018) (discussing sourcing rules).

⁷ Prop. Reg. §1.250(b)-4(e)(1), Prop. Reg. §1.250(b)-4(e)(3).

worldwide.⁸ A binding contract for the license of intangible property, providing that the intangible property can be exploited solely outside the United States, will satisfy the documentation requirement.⁹

The regulations provide the following example of a license of intangible property to an end-user. A domestic corporation (DC) licenses to a foreign person (FP) a limited-use license to copyrighted computer software. The license restricts FP's use of the computer software to end-user use only — it prohibits sublicensing, selling, reverse engineering, or modifying the computer software.¹⁰

The example states that “the software licensed to FP is exploited where its employees that use the software are located.” FP's annual report indicates that all of FP's employees are physically located outside the United States. Thus, all of the royalties would be considered as for the use of the intangible property outside the United States, as established by reference to FP's annual report.

The regulations provide another example modifying the facts of the above example. In this example, the annual report for the taxable year instead indicates that FP has offices both within and outside the United States. The annual report further indicates that 50% of FP's revenue generated from the use of the copyrighted computer software is earned within the United States. The example concludes that 50% of the revenue generated from use of the copyrighted computer software is outside the United States and qualifies as FDDEI.¹¹

When the licensee sublicenses or sells the intangible property, the use of the intangible property is determined based on where the ultimate customer is located. This apparently is the result even if the licensor and licensee are located in a different country than the end-user customer.

The regulations provide the following example of a license of intangible property for replication and distribution by the licensee. DC licenses to FP worldwide

rights to the copyright to composition A in exchange for annual royalties of \$60. FP sells composition A to customers through digital downloads from servers. In the taxable year, FP earns \$100 in revenue from sales of composition A to customers, of which \$60 is from customers located in the United States and the remaining \$40 is from customers located outside the United States. Therefore, \$24 of the royalties qualify as FDDEI (40% x \$60).¹²

DC establishes the foreign use of the intangible property through records received from FP. The records show the amount of revenue earned during the taxable year from sales of composition A and the countries where the revenue was earned.

The regulations make clear that documentation is a prerequisite to treating royalty income as derived for foreign use of intangible property. If in the above example FP instead did not provide documentation to establish that 40% of the revenue was derived outside the United States, then no portion of the royalty would qualify as FDDEI.¹³

The regulations expressly provide that when intangible property is 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 customer when the product is sold to the end-user.¹⁴ Thus, the location of the licensee or its employees, or where the products are manufactured, is not relevant for this purpose.¹⁵

For example, DC owns a patent for an active pharmaceutical ingredient (API) approved for treatment of disease A (“indication”) in the United States and Countries A, B, and C. The patent is registered in the United States and in Countries A, B, and C. DC licenses to FP all of its patent rights to the API for indication A for a royalty of \$1,000x.

The revenue earned by FP for the taxable year from selling a pharmaceutical product incorporating the

⁸ See Prop. Reg. §1.250(b)-3(d) (requirements for reliable documentation).

⁹ The licensor also, as of the FDII filing date (Prop. Reg. §1.250(b)-3(b)(1)), must not know, or have reason to know, that the portion of the royalty from the intangible property for which the seller establishes foreign use is not for a foreign use. Prop. Reg. §1.250(b)-4(e)(1).

¹⁰ Prop. Reg. §1.250(b)-4(e)(4)(ii)(D) Ex. 4.

¹¹ Prop. Reg. §1.250(b)-4(e)(4)(ii)(E) Ex. 5. Reportedly, a Treasury official stated that the reference to revenue inside and outside the United States in this example was not meant to indicate that the location where the product was sold was relevant to the example. Rather, the example was meant to convey that determining the location of the employees was relevant. Velarde, *IRS to Clarify FDII Intangible Property Manufacturing End-User*, 163 Tax Notes 281 (Apr. 8, 2019).

¹² Prop. Reg. §1.250(b)-4(e)(4)(ii)(A) Ex. 1.

¹³ Prop. Reg. §1.250(b)-4(e)(4)(ii)(B) Ex. 2.

¹⁴ The Preamble to the proposed regulations states: “For purpose of determining whether a [licensee] of intangible property is for foreign use, the location where revenue is earned is generally determined based on the location of the end-user customers licensing the intangible property or purchasing products for which the intangible property was used in development, manufacture, sale or distribution.” REG-104464-18, 84 Fed. Reg. at p. 8195.

¹⁵ Property other than intangible property can be considered as used outside the United States if it is subject to manufacture, assembly, or other processing outside the United States. Prop. Reg. §1.250(b)-4(d)(2)(i)(B). The Preamble to the proposed regulations states that no similar rule is provided for intangible property because it is not “subject to” manufacturing, assembly, or processing, and, unlike for tangible property, there is no discussion in the legislative history that indicates that Congress intended to provide an analogous rule for intangible property otherwise used in the manufacturing process. REG-104464-18, 84 Fed. Reg. at p. 8195.

API for indication A was \$5,000x, with 15% of the revenue earned from sales within the United States and 85% of the revenue earned from sales outside the United States. Accordingly, \$850x (85% x \$1,000x) of the royalties is in DC's gross FDDEI for the taxable year.¹⁶

The proposed regulations provide that FDII benefits apply equally to intangible property transferred to a related foreign subsidiary that gives rise to a deemed inclusion under §367(d).¹⁷ DC contributes to FS, a wholly owned foreign subsidiary, the exclusive worldwide rights to patents, trademarks, know-how, customer lists, goodwill and going concern value related to product A in an exchange described in §351. As a result, DC is required to report an annual income inclusion based on the productivity, use or disposition of the contributed intangible property under §367(d). In the current taxable year, FS earns \$1,000x of revenue from sales of product A.

Based on FS's sales records for the taxable year, \$300x of its revenue is earned from sales of Product A to customers within the United States, and \$700 of its revenue is earned from sales of product A to customers outside the United States. Accordingly, 70% of

DC's §367(d) inclusion for the taxable year qualifies as FDDEI.¹⁸

The revenue referenced for purposes of determining the percentage of foreign use is determined on an annual basis based on actual revenue earned by the recipient for the taxable year in which the periodic payment is received. Thus, for example, royalties received in the current year for patent rights used to manufacture a product that is sold in a subsequent year is based on revenues earned by the licensee for the current year.¹⁹

In sum, royalties earned by a domestic corporation from the license of intangible property to a foreign person for use outside the United States generally qualify for an effective tax rate of 13.125%. Under the proposed regulations, royalties satisfy the foreign use requirement to the extent the end-user customer is located outside the United States.²⁰ Taxpayers must ensure compliance with the documentation requirements to support royalties as eligible for FDII benefits and should look for opportunities to enhance the benefits.

¹⁸ Prop. Reg. §1.250(b)-4(e)(4)(ii)(F) Ex. 6.

¹⁹ Prop. Reg. §1.250(b)-4(e)(2)(ii). Additional rules are provided for lump-sum royalties that are based on projections. Prop. Reg. §1.250(b)-4(e)(2)(iii).

²⁰ Comments are requested on what additional rules may be needed for determining the location of revenue generation from end-users and what types of documentation should be accepted to document the location of revenue generation with respect to intangible property. REG-104464-18, 84 Fed. Reg. at p. 8195.

¹⁶ See Prop. Reg. §1.250(b)-4(e)(4)(ii)(C) Ex. 3.

¹⁷ Prop. Reg. §1.250(b)-3(b)(7). The special related-party rules do not apply to a license or sale of intangible property. Prop. Reg. §1.250(b)-6(c)(1).