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Federal Tax ADVISORY ■

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Foreign-Derived Intangible Income

Domestic corporations that export their products or services may be able to claim a new deduction designed to lower the effective tax rate on deemed intangible income from such sales. Most potential users of the deduction have addressed it by now. We focus here on the foreign-derived part.

Nothing happens for purposes of this deduction unless a domestic C corporation exports goods or services. The key is what is an export? The definitions are quite odd and have nothing to do with whether the income from the sale is foreign sourced under the income sourcing rules of the Code.

For property exports, the buyer must be a non-U.S. person and it must buy for foreign use. In theory it is easy enough to identify non-U.S. persons—if you can get your buyer to tell you where it is organized. But what if the buyer plans to take delivery in New Jersey and modify the goods in its plant there in a branch? Well, if you know that, it is not a sale for foreign use.

Should you be on notice because you deliver in New Jersey? Not necessarily. The deduction does not require foreign delivery and does not require that you send the buyer a questionnaire, at least not until regulations are issued.

In many cases, the domestic corporation will sell to its controlled foreign corporation (CFC). It used to be that sellers wanted to hold down the profit on those sales and shift profit to the CFC. Now there may be cases where the seller wants to increase the domestic profit share and hold down the CFC profit. The CFC profit might incur the new global intangible low tax income (GILTI) tax, and more profit in the U.S. nominally taxed at a mere 21% may enjoy an even lower rate with the deduction.

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The export sale to the CFC will qualify if the CFC "ultimately" will sell the property to an unrelated foreign buyer. That should be easy enough to arrange, but in this case the seller will know what its CFC plans to do. Actually, there may be several CFC-to-CFC sales before the goods reach the final foreign buyer for foreign use.

Sales of service have a different requirement. The service recipient must be located outside the U.S. The recipient need not be the buyer, just the recipient. Suppose U.S. corporation A hires U.S. corporation B to provide IT services to A's customers in Europe? Corp B may be able to perform the services from the U.S. for the European persons, who are not even its buyers, and claim the deduction, although that is not entirely clear from the statute.

The foreign-derived intangible income regime is probably the next-best part of the tax act for multinational corporations, after the foreign dividends received deduction. All such corporations should be preparing to use it.

For more information, please contact Jack Cummings at 919.862.2302.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Federal Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

George Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Seth M. Buchwald
404.881.7836
seth.buchwald@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie E. Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Ryan J. Kelly
202.239.3306
ryan.kelly@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Danny Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333