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FDII or Not: Section 250 FDII and GILTI Deduction Regulations Proposed

On March 5, 2019, the IRS and Treasury released proposed regulations on the Section 250 deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). The package contains rules for computing the deduction, particularly its FDII-related components, and applying the taxable income limitation. A welcome provision makes clear that individual controlled foreign corporation (CFC) shareholders making a Section 962 election can claim the 50% GILTI deduction. Other "clarifications" in the proposed regulations present substantial complexity and have little statutory basis.

Background

The tax on GILTI, a remnant of the pre-TCJA Code's worldwide tax system, was intended to preserve the U.S. tax base in the wake of the TCJA's move to a participation exemption regime. But to keep U.S. corporations competitive, the law lowered the effective tax rate on GILTI via the GILTI deduction. The FDII deduction, in turn, was meant to create parity for domestic corporations that earn intangible income directly, rather than through CFCs. Per the preamble to the proposed regulations, Section 250 helps "neutralize" the role of tax considerations in the decision to locate intangibles and related income in the U.S. or in a CFC.

Section 250 allows a deduction for up to 37.5% of FDII and 50% of GILTI (including the Section 78 gross-up attributable to GILTI) for tax years beginning after December 31, 2017, and before January 1, 2026. The percentages drop to 21.875% and 37.5%, respectively, for tax years beginning after 2025. If a corporation's FDII and GILTI exceed its taxable income for the year, the amount of FDII and GILTI are reduced proportionately for purposes of computing the Section 250 deduction. The deduction is generally available only to domestic C corporations, though not RICs or REITs.

Proposed Regulations

The proposed regulations offer detailed guidance (and a vat of acronym alphabet soup) on computing the Section 250 deduction and applying the taxable income limitation. Most of the provisions focus on FDII or the deduction as a whole, given the prior guidance on GILTI under Section 951A (issued in late 2018). But there is a significant (and long-hoped-for) GILTI-specific development: individuals who make a Section 962 election to be taxed as a corporation on Subpart F and GILTI inclusions can claim the 50% GILTI deduction for their GILTI and Section 78 gross-up inclusions.

Full sections of regulations are dedicated to computational and definitional aspects of FDII and its key components, including qualified business asset investment (QBAI, also relevant to GILTI), deduction-eligible income (DEI) and foreign-derived deduction-eligible income (FDDEI), FDDEI from sales of property, and FDDEI from services. The proposed regulations are mostly consistent with the Code, but there are some departures and gap-filling. For example, relying on legislative history, the regulations provide that a corporate partner can claim the Section 250 deduction, adopting an aggregate approach for the partner's FDII calculation. Anti-abuse rules also target transfers to related and, in certain circumstances, unrelated parties to reduce QBAI (and thus inflate FDII).

A notable deviation from the Code is the regulations' expanded definition of "foreign branch income," one of six categories of income excluded from DEI and FDII. Under Prop. Reg. Section 1.904-4(f)(2), issued last November, foreign branch income generally excludes gain from the sale of an interest in a partnership or disregarded entity—unless the branch owns at least 10% of the entity and is engaged in the same or a related business as the entity. The Section 250 regulations, however, include income from the direct or indirect sale of any asset (other than stock) that produces income attributable to the branch, including by reason of selling a partnership or disregarded entity. The IRS and Treasury offer no rationale for this expansion of foreign branch income for Section 250 purposes, despite the statutory and regulatory cross-references to Section 904(d)(2)(J) and Prop. Reg. 1.904-4(f).

On the more technical side, the proposed rules redeploy Section 861 regulations for FDII-related expense allocations and mandate the use of "any reasonable method" to attribute costs of goods sold (COGS). Further, the rules state that a corporation's "foreign-derived ratio"—equal to FDDEI divided by DEI, the fraction multiplied by deemed intangible income to arrive at FDII—cannot exceed one, even if the FDDEI exceeds its DEI due to loss or expense allocations. The IRS and Treasury have devised a five-step ordering rule to coordinate the income-based limitations on deductions under Sections 250, 163(j) (business interest expense), and 172 (net operating loss)—graciously sparing taxpayers and their accountants a tripartite algebra problem. The proposed regulations also provide rules for determining the Section 250 deduction for consolidated groups and allocating it among group members.

All taxpayers claiming the Section 250 deduction will have the attendant pleasure of filing a new Form 8993. Those claiming the FDII deduction specifically must also satisfy qualification and foreign-use documentation rules for sales of property and for certain services, with additional requirements for certain sales and services between related parties.

The proposed regulations would have prospective application, though taxpayers can rely on the provisions before final rules are published in the *Federal Register*. The IRS and Treasury seek comments on a number of issues, such as expense and loss allocation (especially for COGS and net operating loss); partnership-related questions, such as how to account for the Section 250 deduction at the partnership level and whether to treat a partnership as an aggregate or entity in defining FDDEI sales or services; the coordination rule with Sections 163(j) and 172; and whether to adopt or revise de minimis exceptions or anti-abuse rules. Comments are due May 6, 2019.

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