

An overview of the proposed regulations on the FDII and GILTI deduction

In March, the IRS issued proposed regulations that cover determining the amount of the deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). The regs also coordinate the FDII and GILTI deduction with other tax provisions. Here's an overview.

Background

The Tax Cuts and Jobs Act (TCJA) established a "participation exemption system" under which certain earnings of a foreign corporation can be repatriated to a corporate U.S. shareholder without U.S. tax. (This occurs under Internal Revenue Code Section 245A.)

However, Congress recognized that, without any base protection measures, the participation exemption system could further incentivize taxpayers to allocate intangible income to controlled foreign corporations (CFCs) formed in low- or zero-tax jurisdictions. After all, the earnings related to such intangible income could now be repatriated to the United States without incurring any U.S. tax.

Therefore, Congress enacted Sec. 951A. It subjects a U.S. shareholder's GILTI (a new term created by the Act) derived through its CFCs to U.S. tax on a current basis. It is like the taxation of such CFCs' subpart F income under Sec. 951(a)(1)(A).

Most member countries of the Organisation for Economic Co-operation and Development provide a full or partial participation exemption with respect to income of foreign subsidiaries distributed to domestic shareholders. Many countries don't subject active foreign business income of foreign subsidiaries to current tax. Congress recognized that taxing such income at the full U.S. corporate tax rate could hurt the competitive position of U.S. corporations relative to their foreign peers. Therefore, it determined that GILTI earned by such corporations should be subject to a reduced effective U.S. tax rate.

Congress enacted Sec. 250, which provides corporate U.S. shareholders a deduction of:

- 50% for tax years beginning after December 31, 2017, and before January 1, 2026, with respect to their GILTI, and
- The amount treated as a dividend under Sec. 78 that's attributable to their GILTI (referred to as a "section 78 gross-up").

In contrast, a domestic corporation's inclusion of its CFCs' subpart F income is ineligible for the Sec. 250 deduction. Therefore, it's generally subject to U.S. tax at the full corporate rate.

Following passage of the TCJA, income earned directly by a domestic corporation is subject to a 21% rate. Absent a deduction with respect to intangible income attributable to foreign market activity earned directly by a domestic corporation, the lower effective tax rate applicable to GILTI because of the Sec. 250 deduction would perpetuate the pre-Act incentive for domestic corporations to allocate intangible income to CFCs formed in low- or zero-tax jurisdictions.

Therefore, to neutralize the effect of providing a lower U.S. effective tax rate with respect to the active earnings of a CFC of a domestic corporation through a deduction for GILTI, Sec. 250 provides a lower effective U.S. tax rate with respect to FDII earned directly by the domestic corporation through a deduction of 37.5%. This is effective for tax years beginning after December 31, 2017, and before January 1, 2026.

The result of the Sec. 250 deduction for both GILTI and FDII is to help neutralize the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign-market activity — that is, whether to earn such income through its U.S.-based operations or through its CFCs. The IRS has now issued proposed regs on the Sec. 250 deduction.

Amount of the deduction

The Sec. 250 deduction is available only to domestic corporations. For this purpose, the term “domestic corporation” would have the meaning set forth in Sec. 7701(a): an association, joint-stock company or insurance company created or organized in the United States or under the law of the United States or of any state. The definition wouldn’t include a regulated investment company, a real estate investment trust or an S corporation.

The Sec. 250 deduction is unavailable to individuals except in certain cases where an individual makes an election under Sec. 962. (See “Sec. 250 deduction for individuals” below for more information about this election.)

The Sec. 250 deduction is generally intended to reduce the effective rate of U.S. income tax on FDII and GILTI to help neutralize the role that tax considerations play when a domestic corporation chooses the location of intangible income attributable to foreign market activity. But the IRS notes that there’s no indication that Congress intended the Sec. 250 deduction to reduce the effective rate of tax imposed by non-income tax provisions outside of Chapter One of the Internal Revenue Code.

Accordingly, for purposes of the excise tax imposed by Sec. 4940(a), the proposed regs provide that a Sec. 250 deduction wouldn’t be treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income within the meaning of Sec. 4940(c)(3)(A).

If, for any tax year, the sum of a domestic corporation’s FDII and GILTI exceeds its taxable income, the excess is allocated pro rata to reduce the corporation’s FDII and GILTI solely for purposes of calculating the amount of the Sec. 250 deduction. For this purpose, a domestic corporation’s taxable income would be determined without regard to the Sec. 250 deduction. The tax code doesn’t otherwise define “taxable income” for purposes of applying the taxable income limitation of Sec. 250(a)(2).

Generally, a taxpayer’s taxable income is based, in part, upon the availability and proper calculation of deductions. But multiple tax code provisions simultaneously limit the availability of a deduction based, directly or indirectly, on a taxpayer’s taxable income, including:

- Sec. 163(j)(1) (limiting a deduction for business interest), and
- Sec. 172(a)(2) (limiting a net operating loss deduction).

A taxpayer’s net operating loss for a tax year is determined without regard to the Sec. 250 deduction under Sec. 172(d)(9), and a taxpayer’s adjusted taxable income is determined without regard to Sec. 172. But neither Sec. 163(j) nor Sec. 250 prescribes an ordering rule with respect to the other provision.

The proposed regs provide an ordering rule for applying Sec. 163(j) and Sec. 172 in conjunction with Sec. 250. Specifically, the proposed regs provide that a domestic corporation’s taxable income for purposes of applying the taxable income limitation of Sec. 250(a)(2) would be determined after all the corporation’s other deductions are accounted for.

Accordingly, a domestic corporation’s taxable income for purposes of Sec. 250(a)(2) would be its taxable income determined regardless of Sec. 250. Its taxable income would be determined by applying Sec. 163(j) and Sec. 172(a), including amounts permitted to be carried forward to such tax year because of Sec. 163(j)(2) and Sec. 172(b).

5 steps to determining deductions

Because of these proposed regs under Sec. 250 and the proposed regs under Sec. 163(j), a domestic corporation's allowable business interest under Sec. 163(j), its net operating loss deduction under Sec. 172(a) and its Sec. 250 deduction would be determined by following five steps:

1. A domestic corporation would calculate the tentative amount of its FDII and the tentative amount of its Sec. 250 deduction considering all deductions, but disregarding any carryforwards or disallowances under Sec. 163(j), the amount of any net operating loss deduction under Sec. 172(a), and the taxable income limitation of Sec. 250(a)(2) and Prop. Reg. Sec. 1.250(a)-1(b)(2).
2. It would calculate the amount of its business interest allowed after the application of Sec. 163(j), accounting for the amount of its tentative Sec. 250 deduction without regard to the amount of any net operating loss deduction under Sec. 172(a).
3. It would calculate the amount of its net operating loss deduction under Sec. 172(a), considering the amount of its business interest allowed after application of Sec. 163(j) and the taxable income limitation of Sec. 172(a)(2), but without regard to the amount of its Sec. 250 deduction (including its tentative Sec. 250 deduction).
4. It would calculate the amount of its FDII, accounting for the amount of its business interest allowed after application of Sec. 163(j) and the amount of its net operating loss deduction under Sec. 172(a) (determined in steps 2 and 3, respectively).
5. It would calculate the amount of its Sec. 250 deduction after the application of the taxable income limitation of Sec. 250(a)(2) and Prop. Reg. Sec. 1.250(a)-1(b)(2), considering the amount of its business interest allowed after application of Sec. 163(j) and the amount of its net operating loss deduction under Sec. 172(a).

Sec. 250 deduction for individuals

As discussed under "Amount of the deduction" above, the Sec. 250 deduction for FDII and GILTI is available only to domestic corporations. But Sec. 962(a)(1) provides that an individual who's a U.S. shareholder may generally elect to be taxed on amounts included in the individual's gross income under Sec. 951(a) in "an amount equal to the tax that would be imposed under Sec. 11 if such amounts were received by a domestic corporation." (Ask your tax advisor for more information if this is your situation.)

Application of Sec. 250 to consolidated groups

The Sec. 250 deduction is available to a member of a consolidated group ("member") in the same manner as the deduction is available to any domestic corporation. The IRS, however, is concerned that a calculation of a member's Sec. 250 deduction based solely on its items of income and qualified business asset investment (QBAI) may not result in a clear reflection of the consolidated group's income tax liability.

For example, a consolidated group could segregate all its QBAI in one member, thereby decreasing the deemed tangible income return (DTIR) of other members relative to the consolidated group's DTIR if determined at a group level. Alternatively, a strict, separate-entity application of Sec. 250 could inappropriately decrease a consolidated group's aggregate amount of deduction for its FDII. This could occur, for instance, because one member's deemed intangible income (DII), which is the excess of deduction eligible income (DEI) over DTIR, wouldn't be considered in calculating the FDII of another member that has foreign-derived deduction eligible income (FDDEI) more than its DEI.

As a result, the proposed regs provide that a member's Sec. 250 deduction would be determined by reference to the relevant items of all members of the same consolidated group. Definitions in Prop. Reg. Sec. 1.1502-50(f) would result in the aggregation of the DEI, FDDEI, DTIR and GILTI of all members. These aggregate numbers and the consolidated group's consolidated taxable income would then be used to calculate an overall deduction amount for the group. Prop. Reg. Sec. 1.1502-50(b) then would allocate

this overall deduction amount among the members based on their respective contributions to the consolidated group's aggregate amount of FDDEI and the consolidated group's aggregate amount of GILTI.

The proposed regs also address two issues relating to intercompany transactions. First, they'd add an example to Prop. Reg. Sec. 1.1502-13 demonstrating the applicability of the attribute redetermination rule of Prop. Reg. Sec. 1.1502-13(c)(1)(i) to the determination of FDDEI. This example applies the intercompany transaction rules to clearly reflect consolidated taxable income. It doesn't indicate a change in the law. In this example, the attribute redetermination rule applies to gross DEI and gross FDDEI, which are attributes of an intercompany or corresponding item.

Second, the proposed regs provide that, for purposes of determining a member's QBAI, the basis of specified tangible property wouldn't be affected by an intercompany transaction. Accordingly, an intercompany transaction couldn't result in the increase or decrease of a consolidated group's aggregate amount of DTIR or, in turn, an aggregate amount of a deduction.

Reporting requirements

To claim a deduction under Sec. 250 because of having FDII, a taxpayer must calculate its DII, DEI and FDDEI. None of these terms are used in other provisions of the Internal Revenue Code. Thus, pre-existing forms don't collect data relevant to determining these amounts.

In addition, when calculating its deduction under Sec. 250, a taxpayer must determine the application of the taxable income limitation of Sec. 250(a)(2). To effectively administer and enforce Sec. 250, the proposed regs would require the collection of relevant information on new or existing forms.

Under Prop. Reg. Sec. 1.250(a)-1(d), a domestic corporation or an individual making an election under Sec. 962 that claims a deduction under Sec. 250 for a tax year would have to make an annual return on Form 8993, "Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)" (or any successor form) for such year.

Under Sec. 6038(a)(1), U.S. persons who control foreign business entities ("controlling U.S. persons") must report certain information with respect to those entities, including information that "the Secretary determines to be appropriate to carry out the provisions of this title."

Sec. 6038A requires 25% foreign-owned domestic corporations ("reporting corporations") to file certain information returns with respect to those corporations, including information related to transactions between the reporting corporation and each foreign person who is a related party to the reporting corporation. This information is reported on Form 5472, "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business."

The proposed regs address controlling U.S. persons or reporting corporations, as described above, who/that claim a deduction under Sec. 250 determined by reference to FDII with respect to amounts reported. These people or corporations would have to report certain information relating to transactions with foreign business entities or related parties in accordance with Sec. 6038 and Sec. 6038A.

The proposed regs provide that a partnership that has one or more direct or indirect partners that are domestic corporations and that's required to file a partnership return would have to furnish on Schedule K-1:

- The partner's share of the partnership's gross DEI, gross FDDEI, deductions definitely related to the partnership's gross DEI and gross FDDEI, and

- Partnership QBAI for each tax year in which the partnership has gross DEI, gross FDDEI or partnership specified tangible property.

Under Prop. Reg. Sec. 1.6038-3(g)(4), a U.S. person who owns a 10% interest or a 50% interest of a foreign partnership controlled by U.S. persons would be subject to a similar requirement with respect to Schedule K-1.

Applicability dates

Prop. Reg. Sec. 1.250(a)(1) is proposed to apply to tax years ending on or after March 4, 2019. However, under Prop. Reg. Sec. 1.250-1(b), the IRS recognizes that the Prop. Reg. Sec. 1.250(a)(1) rules may apply to transactions that have occurred before the filing of the proposed regs, and that taxpayers may not be able to obtain the documentation required for transactions that have already been completed.

Under Prop. Reg. Sec. 1.962-1(d), the rules under “Sec. 250 deduction for individuals” above are proposed to apply to tax years of a foreign corporation ending on or after March 4, 2019, and with respect to a U.S. person for the tax year in which or with which such tax year of the foreign corporation ends.

Taxpayers may rely on Prop. Reg. Sec. 1.250(a)-1 and Prop. Reg. Sec. 1.962-1(b)(1)(i)(B)(3) for tax years ending before March 4, 2019. Meanwhile, Prop. Reg. Sec. 1.1502-50 is proposed to apply to consolidated return years ending on or after the date of publication of the Treasury decision adopting these rules as final regs in the Federal Register. Taxpayers may rely on Prop. Reg. Sec. 1.1502-50 for tax years ending before the date of publication of the Treasury decision adopting these rules as final regs in the Federal Register.

Prop. Reg. Sec. 1.6038-2(f)(15) and Prop. Reg. Sec. 1.6038A-2(b)(5)(iv) are proposed to apply with respect to information for annual accounting periods beginning on or after March 4, 2019. Moreover, Prop. Reg. Sec. 1.6038-3(g)(4) is proposed to apply to tax years of a foreign partnership beginning on or after March 4, 2019.

Utmost importance

The TCJA has brought a wide variety of tax law changes. The FDII and the GILTI deduction don't get many headlines, but they're of utmost importance to individuals and corporations who/that may qualify for these tax breaks. Work with your CPA to determine the impact on your tax situation. •