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Global Tax Alert

US final GILTI/FDII regulations under Section 250 include guidance on Section 962 elections, pass-through FDII reporting

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The final regulations on the Internal Revenue Code[1] Section 250 deduction for global intangible low-taxed income (GILTI) and foreign-derived intangible income (FDII) (TD 9901) (the Final Regulations) significantly affect individuals and certain trusts that hold direct and indirect interests in controlled foreign corporations (CFCs) and make elections under Section 962. Section 962 elections allow individuals and certain trusts that are US shareholders of CFCs to be taxed on GILTI and subpart F income as if they were a domestic corporation.

This Tax Alert addresses how the Final Regulations affect Section 962 elections. This Alert also highlights certain reporting requirements relevant to partnerships with domestic corporate partners.

For additional discussion of GILTI and the final regulations under Section 951A, see EY Global Tax Alert, *US Final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers*, dated 21 June 2019. For discussion of the proposed Section 250 regulations on which these Final Regulations are largely based, see EY Global Tax Alerts, *US Proposed Section 250 regulations provide guidance on calculating the FDII/GILTI deduction, including qualification of property and services transactions as FDDEI transactions*, dated 12 March 2019 and *US Proposed Section 250 regulations on GILTI/FDII deduction have implications for partnerships, S corporations, trusts, and individual owners of CFCs*, dated 27 March 2019.

Building a better working world

Background on Section 250 deduction

The GILTI regime was enacted in 2017 under the *Tax Cuts and Jobs Act* (TCJA). Under the GILTI regime, a US person owning more than 10% of a CFC's stock on the last day of the CFC's tax year (a US Shareholder) must include GILTI in gross income. GILTI equals the excess (if any) of the shareholder's net CFC tested income for the tax year, over the shareholder's net deemed tangible income return for the tax year. Net tested income is a CFC's net taxable income determined under US tax principles with certain statutory adjustments. A US Shareholder's net deemed tangible income return equals 10% of its share of the CFC's adjusted basis in its qualified business asset investments.[2]

A US corporation's FDII is the amount of income that is deemed to be derived from the corporation's sale of goods, provision of services or license of intellectual property for non-US use.[3] A more detailed discussion of how FDII is determined appears later, as well as in EY Global Tax Alert, *US Final FDII regulations retain proposed regulations' structure, but reduce documentation burden, defer effective date and make important substantive changes to the computation of the IRC Section 250 deduction*, dated 15 July 2020.

Section 250 basically allows a domestic corporation to deduct 37.5% of its FDII and 50% of its GILTI. These percentages will be reduced in tax years beginning after 31 December 2025, to 21.875% for FDII and 37.5% for GILTI. The Preamble to the Final Regulations reiterates that Congress intended these deductions to produce comparable tax rates on income earned from serving foreign markets, regardless of whether that income is earned directly by a domestic corporation or by its CFCs.

Final Regulations permit Section 250 deduction when US Shareholders make Section 962 elections

The US enacted Section 962 to create parity between US Shareholders that invest in CFCs directly and US Shareholders that invest through a domestic corporation. Consistent with this congressional intent, the Final Regulations permit US Shareholders to claim a Section 250 deduction when making a Section 962 election for their GILTI inclusions.[4] In the Preamble to the Final Regulations, Treasury and the IRS recognize that failure to extend the Section 250 deduction to individual taxpayers would create inefficiency and deprive taxpayers of flexibility in structuring their investments.

A Section 962 election has no relevance for purposes of the FDII deduction under Section 250(a)(1)(A), as only domestic corporations may have FDII under Section 250(b).

Section 962 permits US Shareholders (including US Shareholders in an S corporation or partners in a partnership) to elect to apply the US corporate income tax rate, instead of marginal individual rates, to their subpart F income or GILTI. For purposes of computing taxable income under Section 962, Treas. Reg. Section 1.962-1(b)(1)(i)(A) specifies that gross income includes GILTI plus the taxpayer's Section 78 gross-up. In turn, Section 78 requires a domestic corporation to include an amount in its gross income equal to the foreign income taxes that it is deemed to pay under Section 960, computed without regard to the 80% limitation under Section 960(d)(1). Overall, the calculation of taxable income for US Shareholders who make a Section 962 election includes the taxpayer's subpart F income and GILTI (considering tested losses and QBAI), plus the Section 78 gross-up, decreased by the Section 250 deduction.

The Final Regulations clarify that foreign tax credits under Section 960(d) (i.e., foreign income taxes paid by the CFC) for a GILTI inclusion are available to US Shareholders making Section 962 elections. They also discuss how those US Shareholders should carry over deemed-paid foreign tax credits associated with their subpart F income and GILTI inclusions.[5] As with corporate taxpayers, a 20% haircut applies to a US Shareholder's deemed-paid foreign tax credits in the GILTI basket.[6] Additionally, the Final Regulations include an updated example on how to calculate a GILTI inclusion when making a Section 962 election.[7]

Applicability dates

US Shareholders making Section 962 elections may choose to apply the Final Regulations to a foreign corporation's tax years beginning on or after 1 January 2018, and to the US Shareholder's tax year in which or with which the foreign corporation's tax year ends.[8]

US Shareholders who make a Section 962 election must apply the Final Regulations to a foreign corporation's last tax year ending on or after 4 March 2019, and to the US Shareholder's tax year in which or with which the foreign corporation's tax year ends. Provisions permitting a deemed-paid foreign tax credit and clarifying the application of foreign tax credit carryovers for US Shareholders making Section 962 elections apply to a foreign corporation's tax years ending on or after 9 July 2020, and to the US Shareholder's tax year in which or with which the foreign corporation's tax year ends.[9]

Implications

- *Final rules on the Section 250 deduction affect US Shareholders who make a Section 962 election.*
- *Taxpayers who made a Section 962 election on their 2018 and 2019 tax returns may apply the final regulations to those tax years.*
- *The Section 250 deduction for GILTI is currently 50% of a taxpayer's GILTI plus the related Section 78 gross-up. This 50% will decrease to 37.5% beginning in tax years after 31 December 2025.*
- *US Shareholders making Section 962 elections must include Form 8993, "Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)," with their returns on or before the due date for the individual income tax return (including extensions) for the year to which the Section 962 election relates.*

Making a Section 962 election on an amended return

The Final Regulations acknowledge a lack of guidance on whether a US Shareholder can make a Section 962 election on an amended return. The Section 962 regulations instruct a US Shareholder to make the election "by filing a statement to such effect with her return for the tax year with respect to which the election is made."[10]

Generally, courts have found that US Shareholders may amend their income tax returns to make Section 962 elections when the election first has significance. It does not impose an administrative burden on the IRS, and the ability to make a late election does not give the taxpayer a benefit of hindsight that was not intended by Congress. *Dougherty v. Commissioner*, 60 T.C. 917, 942 (T.C. 1973).[11]

The Preamble to the Final Regulations indicates that the Treasury Department and the IRS are considering issuing further guidance on when taxpayers may make a Section 962 election on an amended return. Until such guidance is issued, the Final Regulations permit US Shareholders to make a valid Section 962 election on an amended return for the 2018 tax year and subsequent years, regardless of circumstance, provided the interests of the Government are not prejudiced by the delay as described in Treas. Reg. Section 301.9100-3(c). The Preamble to the Final Regulations includes an example of when a Section 962 election on amended return could prejudice the Government's interest; in the example, the Section 962 election results in an overpayment in a year for which the period to file a refund claim is open and simultaneously increases the amount of US tax due in years for which the assessment period has expired.

To address this issue, Treas. Reg. Section 301.9100-3(c) outlines the following standards for the IRS to use in determining when the Government's interests are prejudiced:

- If granting relief would result in a taxpayer having a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money)
- If the tax year in which the regular election should have been made or any tax years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under Section 6501(a) before the taxpayer's receipt of a ruling granting relief under this section

Implications

- *Treasury and the IRS have acknowledged the need for additional guidance on Section 962, specifically whether a US Shareholder can make the election on an amended return. The Final Regulations permit the Section 962 election to be made on an amended return for tax years 2018 and beyond, as long as it does not prejudice the Government.*

Determining a domestic corporation's FDII

The Final Regulations define a corporation's FDII as equal to its deemed intangible income (DII) multiplied by its foreign-derived ratio (FDR).[12] DII is defined as deduction-eligible income (DEI) minus deemed intangible income return (DTIR).[13] DTIR is calculated as 10% of QBAI, which is the average of a domestic corporation's aggregate adjusted bases of specified tangible property used in a trade or business and eligible for depreciation under Section 167.[14] Finally, the FDR is foreign-derived deduction eligible income (FDDEI) divided by DEI. The regulations indicate that FDR is capped at 1, as FDDEI may not exceed DEI.[15]

To have a FDDEI deduction, a taxpayer must first determine FDDEI transactions, which are separated into FDEEI sales and FDDEI services. A FDDEI sale requires sale of general or intangible property to a foreign end user for foreign use. An end user is the ultimate consumer of property; therefore, a reseller or other intermediary is not an end user for the purposes of FDDEI.[16] To qualify as a FDDEI sale, the end

user must be a foreign person. FDDEI also includes income from services received by a US corporation from any buyer for property not located in the US.[17] Whether a transaction qualifies a sale or service depends on the predominant character of the transaction.[18]

Reporting for single- and multi-tiered partnerships

The Final Regulations require any partnership with one or more domestic corporations as direct partners to furnish on Schedule K-1 the partner's share of the partnership's gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI and gross FDDEI, and partnership QBAI (as determined under Treas. Reg. Section 1.250(b)-2(g)) (together being "partnership FDII attributes").[19] If a controlling 10% partner or a controlling 50% partner claims a deduction under Section 250 that is determined, in whole or in part, with reference to the income, assets or activities of the partnership, the partner must include its share of partnership FDII attributes on its Form 8895 for the tax year.[20]

For tiered partnerships in which one or more domestic corporations are partners of an upper-tier partnership, a lower-tier partnership must report these amounts to the upper-tier partnership to allow proper reporting of Section 250 items by a domestic corporate partner. If the partnership cannot properly determine its partners' allocable share of these amounts in the context of tiered partnerships, the partnership must instead furnish to each partner its share of the partnership's attributes that the partner needs to determine its gross DEI, gross FDDEI, deductions that are properly allocable to its gross DEI and gross FDDEI, and its adjusted bases in partnership-specified tangible property.

Applicability dates

The Final Regulations under Treas. Reg. Sections 1.250(a)-1 and 1.250(b)-1 through -6 apply to tax years beginning on or after 1 January 2021. The anti-abuse rules in Treas. Reg. Section 1.250(b)-2(h), which govern sale-lease back transactions with a principal purpose of decreasing DTIR, apply to tax years ending on or after 4 March 2019. Taxpayers may elect to apply the final regulations in full for tax years beginning on or after 1 January 2018, and before 1 January 2021.[21]

Implications

- *The Final Regulations retain the partnership reporting requirements provided in the proposed regulations. The Final Regulations clarify that reporting rules for tiered partnerships are largely consistent with those applying to single partnerships.*
- *Partnerships should timely report each of the items prescribed in the Final Regulations with the Schedule K-1 furnished to each partner.*

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Section 951A; Treas. Reg. Section 1.951A-1 *et. seq*.
3. Section 250(b)(1); Treas. Reg. Section 1.250(b)-1 *et. seq*.
4. The Section 962 election has no relevance in the context of the FDII deduction provided under Section 250(b).
5. Treas. Reg. Section 1.962-1(a)(2); Treas. Reg. Section 1.962-1(b)(2)(ii) -= (iii).
6. Treas. Reg. Section § 1.962-1(c).
7. *Id*.
8. *Id*.
9. Treas. Reg. Section 1.962-1(d).
10. Treas. Reg. Section 1.962-2(b).

11. The IRS's historic position seems to be that the phrase "return for the tax year," as used in the regulations, reasonably contemplates the taxpayer's originally filed return, not an amended return filed after the original return's due date (including extensions). GCM 36325, however, implies that an Section 962 election on an amended return would be valid under some circumstances. According to the 11 August 1965 memo, the IRS Legislation and Regulations Division received a taxpayer inquiry about whether the proposed version of Treas. Reg. Section 1.962-2 (1965) allowed an Section 962 election to be made on an amended return but considered it unnecessary to modify the regulation to expressly permit such an election.
12. Treas. Reg. Section 1.250(b)-1(b).
13. Treas. Reg. Section 1.250(b)-1(c)(2).
14. Treas. Reg. Section 1.250(b)-1(c)(4), (18); Treas. Reg. Section 1.250(b)-2.
15. Treas. Reg. Section 1.250(b)-1(c)(13).
16. Treas. Reg. Section 1.250(b)-3(b)(2); Treas. Reg. Section 1.250(b)-4.
17. Treas. Reg. Section 1.250(b)-5.
18. Treas. Reg. Section 1.250(b)-3(d).
19. Treas. Reg. Section 1.250(b)-1(e)(2).
20. Treas. Reg. Section 1.6038-3(g)(4).
21. Treas. Reg. Section 1.250(a)-1(b).

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