12 March 2019

Global Tax Alert

US Proposed Section 250 regulations provide guidance on calculating FDII/GILTI deduction, including qualification of property and services transactions as FDDEI transactions

NEW! EY Tax News Update: Global Edition

EY's new Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration here.

Also available is our EY Global Tax Alert Library on ey.com.

Executive summary

In proposed regulations under Internal Revenue Code[1] Section 250 (REG-104464-18) (the Proposed Regulations), the United States (US) Treasury Department (Treasury) provides guidance for calculating the deduction allowed to a domestic corporation for its foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). The Proposed Regulations primarily provide guidance for calculating a domestic corporation's FDII; proposed regulations for calculating GILTI were released 13 September 2018.[2]

Detailed discussion

Background

Section 250 generally allows a domestic corporation a deduction for its FDII and GILTI inclusions for a tax year. For tax years beginning after 31 December 2017, but on or before 31 December 2025, a domestic corporation may claim a deduction equal to 37.5% of its FDII, and 50% of the sum of its GILTI and any Section 78 dividend with respect to GILTI (Section 78 GILTI dividend). For tax years beginning after 31 December 2025, these percentages decrease to 21.875% and 37.5%, respectively. If, however, for any tax year the sum of a domestic corporation's FDII and GILTI exceeds its taxable income (determined

Building a better working world

without regard to the Section 250 deduction), the amount of FDII and GILTI taken into account to determine the allowed Section 250 deduction decrease proportionately to eliminate the excess.[3]

A domestic corporation's FDII for a tax year is the amount that bears the same ratio to its deemed intangible income (DII) as its foreign-derived deduction-eligible income (FDDEI) bears to its deduction eligible income (DEI) (the ratio, "the foreign-derived ratio").

- A domestic corporation's DEI is the excess, if any, of: (i) its gross income, without regard to any inclusion under Section 951(a)(1) (subpart F income inclusion), any GILTI inclusion, any financial services income (as defined under Section 904(d)(2)(D)), any dividends received from a CFC in respect of which it is a US shareholder, any domestic oil and gas extraction income, and any foreign branch income (as defined under Section 904(d)(2)(J)), (the resulting gross income, "gross deduction eligible income") over (ii) the deductions, including taxes, properly allocable to such gross deduction eligible income.
- A domestic corporation's FDDEI is generally any DEI derived in connection with: (i) property sold to any non-US person for foreign use; or (ii) services provided to a person, or with respect to property, not located within the US.[4]
- A domestic corporation's DII is the excess, if any, of its DEI over its deemed tangible income return (DTIR), which equals 10% of the domestic corporation's qualified business asset investment (QBAI) for the year.

A sale of property to an unrelated person for further manufacture or modification within the US will not be treated as sold for foreign use, even if the other person subsequently uses the property for a foreign use. Similarly, services provided to an unrelated person located in the US will not qualify for foreign use, even if the other person uses the services to provide services for foreign use. Exceptions to these general intermediary rules are provided, however, for property sales or services provided to related foreign persons.

Proposed Regulations

The Proposed Regulations provide guidance for determining the components of a domestic corporation's FDII calculation — namely, DEI, DTIR, DII and FDDEI. Detailed rules are further provided to determine the sub-components of certain components. For example, and most importantly, separate rules provide the extent to which property is sold or services are provided for foreign use, with additional rules provided for different types of property and different types of services. In addition, different documentation rules are provided for different types of transactions to establish foreign use. Further, guidance is provided to coordinate the calculation of the allowed Section 250 deduction with the application of other limitations in the Code (Sections 163(j) and 172(a)) that are based on a domestic corporation's taxable income for a tax year. Finally, special rules are provided for individuals that make a Section 962 election for a tax year, consolidated groups, and tax-exempt corporations.

Computation of FDII

Consistent with the statute, the calculation of FDII under the Proposed Regulations is a multi-step process that begins with the concepts of "gross DEI" and "gross FDDEI." All gross FDDEI is included in gross DEI, but not all gross DEI is included in gross FDDEI. After calculating the gross amounts, deductions of the domestic corporation are allocated against the gross items to arrive at DEI and FDDEI. Depending on attribution of COGS (discussed later) and allocation/apportionment of deductions (also discussed later) FDDEI may be greater than DEI, or vice versa. When both amounts are positive, and DEI is greater than DTIR, subject to the taxable income limitation of Section 250(a)(2), the domestic corporation will be allowed a Section 250 deduction; if DEI is zero or negative, the domestic corporation will not be allowed a deduction. If a domestic corporation's FDDEI exceeds its DEI and would otherwise result in a foreign-derived ratio exceeding one (e.g., due to losses attributable to domestic market sales), the Proposed Regulations provide that the ratio of FDDEI to DEI could not exceed one. As a result, careful application of the mechanical rules and consideration of the various decisions to be made in that application (e.g., attribution of COGS, allocation of deductions, etc.) is critical.

Excluded gross income. Consistent with the Code, the Proposed Regulations would exclude from these items (i) inclusions under Section 951(a)(1) (including any associated Section 78 dividend); (ii) GILTI inclusions (including any associated Section 78 dividend); (iii) financial services income (as defined in Section 904(d)(2)(D); (iv) dividends received from certain CFCs; (v) domestic oil and gas income; and (vi) foreign branch income. In a change from the statute, the Proposed Regulations would include in foreign branch income any income or gain that would not be attributed to the foreign branch income category under Section 904(d)(1)(B) but that arise from a direct or indirect sale of any asset (other than stock) that produces gross income attributable to a foreign branch, including by reason of the sale of a disregarded entity or partnership interest. This broader definition of a foreign branch is yet another consideration for domestic corporations considering incorporating foreign branches that currently hold IP because any income inclusions under Section 367(d) would appear to be treated as foreign branch income for this purpose and thus not eligible for gross DEI and gross FDDEI treatment.

Attribution of cost of goods sold. For purposes of determining the amount of gross income attributable to separate income items that are part of gross DEI and gross FDDEI, the Proposed Regulations would require an attribution of cost of goods sold (COGS) to gross receipts under any reasonable method. This attribution would be required even for COGS associated with activities undertaken in prior tax years. A domestic corporation could not, however, segregate COGS into component costs and disproportionately attribute them to amounts not included in gross DEI or gross FDDEI. Of the six items excluded from gross DEI and gross FDDEI, COGS would likely be attributable only to domestic oil and gas income and foreign branch income, which would suggest the majority of a domestic corporation's COGS would be reflected in its gross DEI and to a lesser extent gross FDDEI. Attributing COGS would be a new concept to many international tax practitioners, as its exercise is likely different from allocating and apportioning expenses under Section 861 (which is relevant for determining DEI and FDDEI). A similar concept is used in Section 199, however, which could provide guidance for this purpose.

Allocation of deductions. After determining gross DEI and gross FDDEI, the domestic corporation would have to allocate deductions against such items to arrive at DEI and FDDEI, respectively. The Proposed Regulations clarify the allocation of deductions against FDDEI. The statute provides simply that FDDEI is DEI derived from specified transactions. The Proposed Regulations clarify that deductions are allocated and apportioned to gross FDDEI and gross non-FDDEI, and that the sum of the two equals the deductions allocated to gross DEI. As expected, the rules of Treas. Reg. 1.861-8 through 1.861-14T and 1.861-17 would be applied to allocate and apportion deductions against gross DEI and gross FDDEI to arrive at DEI and FDDEI. For reasons not explained in the Preamble, however, R&D expenditures would be allocated without regard to the exclusive geographic apportionment rule of Treas. Reg. Section 1.861-17(b).

Partnerships. The Proposed Regulations would treat a partnership as a person for purposes of determining whether a sale or service rendered to or by a partnership is a FDDEI transaction. Thus, gross DEI and gross FDDEI (as well as QBAI, discussed later) would be calculated at the partnership level. A partnership is not, however, eligible to claim a FDII deduction because it is not a domestic corporation. Thus, the Proposed Regulations provide that a domestic corporate partner would take into account its distributive share of partnership gross DEI, gross FDDEI, and deductions in order to calculate the partner's FDII. A partner's distributive share would be determined in accordance with the partner's distributive share of the underlying items of income, gain, deduction and loss of the partnership.

FDDEI calculation

FDDEI equals the excess, if any, of the domestic corporation's gross FDDEI over the domestic corporation's deductions properly allocable to gross FDDEI. The domestic corporation's gross FDDEI equals the portion of the domestic corporation's gross DEI that is derived from the domestic corporation's "FDDEI transactions." The Proposed Regulations define FDDEI transactions as a FDDEI sale or a FDDEI service.

FDDEI sales. Regarding property sales, the Proposed Regulations provide different qualification and documentation rules for general property (general property sales) and intangible property as defined in Section 367(d)(4) (intangible property sales).[5] Special rules are further provided for general property sales that involve international transportation property (e.g., planes, trains or automobiles). Regardless of the property type, however, the seller would have to obtain specified documentation to establish the recipient of the property is a foreign person and to prove foreign use. The Proposed Regulations also provide special rules for sales to foreign related parties.

General property. The sale of general property, other than international transportation property, would be considered for a foreign use if the property is not subject to a domestic use within three years of the date of delivery or is subject to manufacture, assembly or other processing outside the US before the property is subject to a domestic use. Domestic use for this purpose would consist of any use, consumption, disposition, manufacturing, assembly or other processing in the US. General property would be subject to further manufacturing, assembly or other processing if it is physically or materially changed (as determined under the facts and circumstances) or incorporated as a component into a second product (as determined by a value-based, mathematical test). Specifically, general property would be treated as a component of a second product only if the fair market value of all general property sold by the seller and incorporated into the second product constitutes no more than 20% of the fair market value of the second product. To illustrate this concept, assume a domestic corporation sells wood pulp to an unrelated foreign person that uses the wood pulp to manufacture paper in a foreign jurisdiction. The paper is then sold to consumers in the US. The sale of the wood pulp to the foreign person is considered for foreign use because it would subject to manufacture and processing outside the US before it was subject to domestic use.

International transportation property would be treated as a subset of general property and consist of "aircraft, railroad rolling stock, vessel, motor vehicle, or similar property that provides a mode of transportation and is capable of traveling internationally." Sales of international transportation property would be for foreign use only if, during the three years from the date of delivery, the property were located outside the US more than 50% of the time and more than 50% of the miles traversed in the use of the property were traversed outside the US.

The Proposed Regulations specify the documentation a seller must obtain to substantiate foreign use, with special rules provided for sales of international transportation property, and "fungible mass" of general property when tracing specific property is challenging.

Intangible property. A sale of intangible property would be for foreign use only to the extent that the intangible property generates revenue from exploitation outside the US. If intangible property is used to develop, manufacture, sell or distribute products, the intangible property would be treated as exploited based on the location of the end user. For IP exploited both outside and within the US, special rules are provided to determine the portion of the IP transferred for foreign use.

Military sales. For purposes of Section 250(b), sales by a domestic corporation to the US government for re-sale to a foreign government under the *Arms Export Control Act* would be treated as sales by a domestic corporation to a foreign government. The sales would still have to meet the requirements of -3 through -6 of the Proposed Regulations, including documentation requirements. The Proposed Regulations do not include guidance on how taxpayers can demonstrate that sales were made under the *Arms Export Control Act*. Treasury and the Internal Revenue Service request comments on whether the final regulations should include such guidance.

Related-party sales. The statute provides more restrictive rules for sales to related parties than to unrelated parties. Specifically, the statute treats a sale to a foreign related party as for a foreign use only when the property sold is resold by the foreign related party for foreign use or by the foreign party used in connection with the sale of other property or provision of services for a foreign use. The Proposed Regulations provide guidance on how foreign use is determined in these cases. Under the Proposed Regulations, a related-party sale of general property would qualify as a FDDEI sale only if either (i) the foreign related party resells the property to an unrelated foreign person (either on its own or as a component part of other property), or (ii) the seller reasonably expects the property to be used in connection with a sale of other property, or the provision of services, to an unrelated foreign party (either (i) or (ii) is defined as an "unrelated transaction"). The taxpayer would also have to meet additional requirements for each type of unrelated transaction, as provided next. Additionally, the foreign related party would have to comply with the documentation requirements. The Proposed Regulations would treat all foreign related parties as if they were a single foreign related party.

When the related party resells the property, the unrelated transaction would have to qualify as a FDDEI sale under the rules described previously in the FDDEI sales section and the unrelated transaction would have to occur on or before the FDII filing date. If the unrelated party transaction does not occur on or before the FDII filing date, the taxpayer would need to amend its return for the year in which the related-party sale occurred to claim the benefit once the unrelated transaction occurs.

When the foreign related party uses the purchased property to produce other property or to provide a service, the Proposed Regulations would require the seller to reasonably expect that the unrelated party transaction would qualify as a FDDEI sale or FDDEI service under the rules described in the previous sections (without regard to the documentation rules). Additionally, the seller would have to reasonably expect that more than 80% of the revenue earning by the foreign related party would be earned from unrelated FDDEI transactions.

The Proposed Regulations explicitly provide that the related-party sales rules in the statute and the Proposed Regulations do not apply to sales of IP. The Preamble notes that no additional rules are needed for related-party IP sales because a sale of IP qualifies only to the extent the IP is exploited outside the US.

Example

Domestic Corporation sells a machine to a foreign related person, which uses the machine to manufacture widgets that it sells to unrelated persons both within and outside the US. The sale of the machine will qualify as a FDDEI sale under the related-party sales rules only if more than 80% of the sales of the widgets are to unrelated persons outside the US.

Conversely, if Domestic Corporation licenses IP to a foreign related party that uses the IP to manufacture software that it sells to unrelated persons both within and outside the US, then, under the general rule, the royalty income earned by Domestic Corporation would generally qualify as a FDDEI sale in proportion to foreign related person's income from software sales outside the US.

FDDEI services. The Proposed Regulations provide rules for determining foreign use for four categories of services: (i) property services, (ii) proximate services, (iii) transportation services, and (iv) (residual) general services. General services are further divided between services provided to individuals for personal consumption (consumers) and other recipients (business recipients). Each category is exclusive of the others. Because the general services are a residual category, the proposed rules would cover all services. Unlike for property sales, documentation to substantiate foreign use would be required only for general services.

A transportation service is a service to transport a person or property using aircraft, railroad rolling stock, a vessel, a motor vehicle or any similar mode of transportation. Transportation services would be considered provided to a recipient, or with respect to property, located outside the US, if both the origin and destination of the service were outside the US. If either the origin or the destination (but not both) of the service were within the US, 50% of the service would be considered for foreign use.

A property service is a service, other than a transportation service, provided for tangible property if substantially all the service is provided at the location of the property and the service results in the physical manipulation of the property, such as through assembly, maintenance or repair. The Proposed Regulations consider substantially all the service provided at the location of the tangible property only if the service provider spends at least 80% of the time providing the service at or near the location of the property. This 80% threshold appears to be a bright-line test, so it is unclear whether a lesser percentage of time spent at or near the location of the property can satisfy the substantially-all standard. For example, if a domestic corporation (DC) has a maintenance contract to service a machine and DC's employees provide all services at the customer's location outside the US, the maintenance services will be property services that qualify as FDDEI services. If, however, 50% of the services consist of on-location servicing and 50% consist of other activities performed by DC's employees at DC's location in the US, it appears that the services would not be property services because substantially all services are not provided at the location of the machine. Some portion of the services may, however, still qualify as FDDEI services under the general services rule discussed later.

A proximate service is a service, other than a transportation or property service, provided to a recipient but only if substantially all of the service is performed in the physical presence of the recipient, or in the case of a business recipient, its employees. Like a property service, for this purpose, substantially all the service is performed in the physical presence of the recipient or its employees if the service provider spends at least 80% of the time providing the service in the physical presence of the recipient or its employees.

A similar question exists as to whether the substantially-all standard is a facts-and-circumstances determination or whether 80% is a bright-line threshold. The recipient would be treated as located where the service is performed. For services performed partly within the US, the Proposed Regulations provide for an allocation. For example, if a domestic corporation (DC) provides training services to employees of a business recipient (BR) at BR's location, the services would be treated as proximate services and would qualify as FDDEI services, provided BR is located outside the US. Alternatively, if DC provides 50% of the services remotely, the services would not be proximate services.

A general service is any service other than a transportation service, a property service, or a proximate service. Whether a general service is for foreign use depends on whether the recipient is the end-consumer (an individual) or a business recipient. A general service provided to a consumer would be considered provided in the location where the consumer resides when the service is provided. The Proposed Regulations specify the documentation that must be obtained by the renderer of the service to document the location of the consumer. In contrast, whether a general service provided to a business recipient is provided outside of the US depends on the extent to which the business recipient's operations outside of the US benefit from the service. Generally, the amount of the benefit provided to the business recipient's operations outside (or inside) the US is "determined under any method that is reasonable under the circumstances." This standard differs from the "any reasonable method standard" and is to be generally determined by applying the principles of Treas. Reg. 1.482-9(k). The use of this transfer pricing provision, which generally applies for purposes of allocating costs between members of a controlled group when a controlled transaction benefits more than one member of the controlled group, is an interesting choice outside the context of controlled transactions. The Proposed Regulations provide, however, that reasonable methods may include allocations based on time spent or costs incurred by the service provider, or gross receipts, revenue, profits, or assets of the business recipient.

A business recipient would be treated as having operations where it maintains an office or other fixed place of business. If the business recipient's business presence is entirely outside the US, determining how the general services benefit the business recipient will be relatively straightforward. In more complicated fact patterns (which will be the norm), however, this concept of identifying the extent to which general services benefit a business recipient's US and non-US operations is certain to be an involved, complicated exercise that will require application of transfer pricing principles in a manner not generally needed for other purposes of the Code.

Military services. Like the rules previously discussed, the Proposed Regulations would treat services provided by a domestic corporation to the US government for on-service to a foreign government under the *Arms Export Control Act* as provided to the foreign government, provided the other requirements for FDDEI services are met.

Related-party services. As with sales to foreign related parties, the statute adds additional requirements for services provided to a foreign related person to qualify as a FDDEI service. Specifically, a service provided to a related party not located in the US (a related-party service) will not be a FDDEI service unless the related-party service is "not substantially similar" to services the related person provides to persons located in the US. The Proposed Regulations would narrow this broad rule by providing that services provided by the related party to persons located in the US will be substantially similar only if the related-party services are used to provide a service to persons located in the US and one of two quantitative tests are met. The first test (the benefits test) would be satisfied if 60% or more of the benefits of the related-party service were to persons located in the US. The second test (the price test) would be satisfied if 60% or more of the price paid by persons located in the US for the service provided by the related party were attributable to the related-party services. If a service were considered substantially similar because of satisfying the price test, a portion of the gross income from the related party service could still qualify as a FDDEI service. The Proposed Regulations would apply the related-party services rules only to a general service provided to a business recipient and not to any other type of service.

For example, assume a foreign corporation (FC) enters into a services agreement with an unrelated corporation (MNC) to provide market research for use in its own advertising. MNC pays Foreign Corporation $200x for the services. FC enters into an agreement with a domestic corporation (DC) under which DC will provide market research for North and South America in exchange for $150x, which FC will use to deliver services to MNC. MNC provides FC a statement that 80% of its business operations are located outside the US. Under the benefit test, because 80% of the services provided by DC relate to MNC's business operations outside the US, only 20% of the services provided by DC are treated as related to MNC's US business operations. Therefore, the market research services provided by DC are not substantially similar to the market research services provided by FC to MNC under the benefits test. Under the price test, 20% of the price paid by MNC (20% x $200x, or $40x) is treated as paid by persons located in the US. Similarly, of the $40x treated as paid with respect to MNC's US operations, $30x (20% x $150x) is treated as attributable to the market research provided by DC. As a result, 75% ($30x / $40x) of the price paid by MNC (treated as located in the US) to FC is treated as attributable to the services provided by DC. Therefore, under the price test, the market research services that DC provides to FC are considered substantially similar to the market research services that FC provides to MNC. Because DC's services to FC are considered substantially similar to the services that FC provides to MNC solely under the price test, the amount of DC's gross income from the services qualifying as FDDEI is $120 (80% x $150x), the percentage of the services conferred on MNC's operations outside the United States.

Partnerships. A sale from a domestic corporation to a foreign partnership would qualify a FDDEI transaction because the partnership is a foreign person. Further, a sale from a domestic corporation to a domestic partnership would not qualify a FDDEI transaction because the sale is to a domestic person. A sale or service rendered by a domestic partnership to a foreign person would generally be a FDDEI transaction.

If, however, a sale or service rendered by a partnership is attributable to a foreign branch, the income would not be a FDDEI transaction because foreign branch income is excluded under Section 250(b)(3)(A).

FDDEI transactions — documentation & reliability requirements

To treat sales or services as FDDEI, the Proposed Regulations would require the seller of property or renderer of services to collect certain documentation to establish the facts necessary for the gross income from the transaction to be treated as FDDEI. The Proposed Regulations provide specific types of documentation that satisfy the documentation requirements for each type of transaction when documentation is required. The seller or renderer would generally have to obtain the documentation no later than the "FDII filing date" and no earlier than one year before the date of the sale or service. The "FDII filing date" is the due date, including extensions, for the income tax return for the tax year in which the gross income from the sale or service is included in the gross income of the seller or renderer.

The Proposed Regulations provide specific types of documents that satisfy the documentation requirements for each type of transaction. The types of documents differ based on what the seller or renderer must establish for a transaction to qualify as a FDDEI transaction. The documents that can be used generally consist of: statements by the recipient as to foreign status, intended use, or intended location of use; valid identification provided by a foreign government (in the case of individuals); contractual documents between the parties; publicly available information (such as annual reports or audited financial statements); or other documents prescribed by the Secretary in forms or subsequent guidance. For lump-sum intangible property sales or non-contingent sales of intangible property to third parties, a seller could establish foreign use through documentation containing financial projections of the amount and location of revenue the seller would have reasonably expected to earn from exploiting the property. Such documentation would have to be consistent with the financial projections used to determine the sales price.

The Proposed Regulations provide exceptions for fungible mass sales, transactions undertaken by small businesses, or small transactions, when documentation requirements would otherwise apply. For fungible mass sales that cannot reasonably be specifically traced, the Proposed Regulations would allow a seller to establish foreign use through statistical sampling, economic modeling or other similar methods. When a seller or renderer is a small business (less than $10 million in gross receipts in the prior tax year, annualized in the case of short years) or for small transactions (less than $5,000 in gross receipts from a recipient in a tax year) the seller or renderer may establish foreign-person status, foreign use, or location outside the US (as relevant for each transaction) by using the recipient's shipping address.

To rely on the documentation, the seller or renderer must not know or have reason to know that the documentation is unreliable or incorrect as of the FDII filing date. The Proposed Regulations would treat the seller or renderer as knowing or having reason to know that documentation is unreliable or incorrect if the seller or renderer's knowledge of the relevant facts and/or statements is such that a "reasonably prudent person" would question the accuracy or reliability of the documentation. The Proposed Regulations include a special rule for loss transactions. When the seller or renderer knows or has reason to know that a sale or general service would otherwise meet the requirements for a FDDEI sale or service, but the seller or renderer fails to meet the documentation requirements, the transaction would be deemed to be a FDDEI transaction if not treating it as a FDDEI transaction would increase the corporation's FDII deduction for the year.

Qualified business asset investment

A domestic corporation's QBAI is the average of its aggregate adjusted bases in specified tangible property used in the production of deduction-eligible income that (i) the domestic corporation uses in a trade or business and (ii) is a type for which a deduction is allowed under Section 167. Specified tangible property of a domestic corporation includes the adjusted basis of "dual-use property" based on the same proportion that the DEI bears to the total gross income produced (the dual-use ratio). "Dual-use property" is property that produces DEI and gross income that is not DEI.

The adjusted basis in any property, for purposes of Section 250(b), should be determined using the alternative depreciation system (ADS) under Section 168(g). The Proposed Regulations clarify that ADS should apply to all property for purposes of Section 250(b), even if that property was placed into service before 22 December 2017. The rule would apply as if ADS had been used from the date the property was placed in service.

The Proposed Regulations provide special rules for short tax years. When a domestic corporation has a tax year that is less than 12 months, the domestic corporation's QBAI is the aggregate adjusted bases in its specified tangible property at the close of each full quarter divided by four (quarters in a year), plus the aggregate adjusted bases in the specified tangible property at the close of each short quarter, multiplied by the number of days in the short quarter over 365 (days in a year).

Application to partnerships. A domestic corporation that holds a partnership interest at the end of the domestic corporation's tax year, increases its QBAI by its share of the partnership's adjusted basis in the partnership specified tangible property (partnership QBAI). The domestic corporation's share is calculated using the partnership QBAI ratio. The partnership's adjusted basis in specified tangible property and the portion taken into account in determining a domestic corporation's partnership QBAI would be determined by applying the principles applicable to domestic corporations described previously.

Anti-abuse rules. The Proposed Regulations include anti-abuse rules for transfers of specified tangible property to related parties and certain unrelated parties. A domestic corporation would be treated as owning specified tangible property that it transfers to a "specified related party" if (i) the corporation transfers the property with a principal purpose of decreasing its deemed tangible income return, and (ii) the domestic corporation or a FDII-eligible related party (i.e., a member of the same domestic consolidated group or a partnership at least 80% of which is owned by members of the consolidated group) leases the same or substantially similar property back during the "disqualified period." The disqualified period is the period beginning one year before the transfer and ending the earlier of (i) the end of the remaining recovery period of the property or (ii) one year after the date of the transfer.

A transfer or lease to an unrelated party would be treated as made to a specified related party if done under a "structured arrangement." A structured arrangement will exist if (i) the reduction to the domestic corporation's deemed tangible income return is a material factor in pricing the transfer or lease, or (ii) a principal purpose of the arrangement (applying a facts-and-circumstances test) is the reduction in the domestic corporation's deemed tangible income return.

A transfer of property to a specified related party (or a party deemed to be a specified related party), followed by a lease back of the same or substantially similar property within six months of the transfer, would be treated as per se having a principal purpose of decreasing the domestic corporation's deemed tangible income return.

Coordination rule — Sections 163(j), 172, and 250

The Proposed Regulations provide a multi-step process to coordinate the application of Sections 163(j) (limitation on business interest), 172 (net operating loss (NOL) deductions), and 250. This multi-step process eliminates the circularity inherent in the Code and is in lieu of requiring "simultaneous equations" to be applied for this purpose, which is welcome relief.

Individuals who make Section 962(d) elections

Section 962 allows an individual with subpart F income or GILTI inclusions to be taxed as a corporation with respect to those inclusions to provide parity with individuals who invest in foreign corporations through a domestic corporation. To maintain this parity, the Proposed Regulations would allow a Section 250 deduction for an individual's GILTI inclusion in place a Section 962 election.

Application to consolidated groups

The Section 250 deduction is available to a consolidated group member, consistent with the framework for determining each member's separate taxable income by taking into account all items other than those explicitly taken into account at the group level. The Proposed Regulations would take an approach to a consolidated group by aggregating certain member items into a consolidated group "bucket" and then allocating those items back to the members proportionately. As described later, the Proposed Regulations would (i) determine the Section 250 deduction by reference to the relevant items and attributes of all members of the group, (ii) apply attribute redetermination under Reg. Section 1.1502-13(c) to determine each member's FDDEI, (iii) prevent intercompany transactions from affecting QBAI, and (iv) treat income offset by the Section 250 deduction as tax-exempt income for purposes of basis adjustments in member stock.

More specifically, the Proposed Regulations would determine the consolidated group's Section 250 deduction by referencing the relevant items of all members of a consolidated group, aggregating each member's DEI, FDDEI and DTIR, and also aggregating each member's GILTI inclusions (and associated Section 78 dividends). A consolidated group would calculate its aggregate FDII by using the members' aggregate DEI, FDDEI and DTIR (the location of QBAI ownership as between members of a consolidated group (or their tested income CFCs) is not relevant), and then would reduce the aggregate FDII, if necessary, under the consolidated taxable income limitation. This limitation (similar to the taxable income limitation in the separate-entity context), would reduce a group's FDII and GILTI (and associated Section 78 dividends) proportionately to the extent that, in aggregate, they exceed CTI (with CTI taking into account all items (including business interest expense allowed under Section 163(j) and the NOL deduction under Section 172) other than the Section 250 deduction). The group then would allocate the consolidated FDII deduction amount (for years beginning before 1 January 2026, the group's aggregate FDII multiplied by 37.5%) to each member in proportion to relative positive FDDEI. Similarly, a group would aggregate the GILTI inclusions (and associated Section 78 dividends) of each member, reduce these aggregate amounts, if necessary, by reason of the CTI limitation, and then allocate the resulting deduction (for years beginning before 1 January 2026, the aggregate GILTI and Section 78 dividends multiplied by 50%) to each member in proportion to relative GILTI (and associated Section 78 dividends).

The Proposed Regulations would apply attribute redetermination under Reg. Section 1.1502-13(c) to determine each member's FDDEI. This would not be a change in law, but rather would be an extension of existing single-entity attribute-redetermination principles through the addition of an example. As illustrated by the example, in determining whether gain of a selling member (S) is DEI and/or FDDEI (attributes of S's gain), S and the buying member (B) are treated as divisions of a single corporation. If B subsequently sells the property to a foreign person for a foreign use, then S's item (in addition to B's item) could qualify as FDDEI, notwithstanding that S sold the property to B, a US person. Similarly, if S sells property at a loss to B, S's loss is allocated solely to B's gross income from the property for purposes of determining B's DEI and FDDEI.

The Proposed Regulations would prevent an intercompany transaction from affecting QBAI. Generally, an intercompany transaction can affect a member's basis in assets because basis is determined under relevant Code rules. For example, if B buys property from S for cash in a Section 1001 transaction, B takes a Section 1012 cost basis in the property. If an intercompany transaction changed the basis in tangible depreciable property for purposes of determining QBAI, however, then this would allow an intercompany transaction to affect CTI, which would be inconsistent with single entity principles. Thus, a special rule would cause a member's basis in property to exclude amounts realized by another member in an intercompany transaction, regardless of whether the amount realized were taken into account. This is similar to the rule in the Proposed Section 163(j) regulations that would disregard basis from intercompany transactions for purposes of adding back depreciation to calculate adjusted taxable income. An intercompany transaction would not affect QBAI even if gain or loss from the transaction were accelerated (for example, if S ceased to be a member of the group).

Finally, the Proposed Regulations would treat the amount of a member's income offset by the Section 250 deduction as tax-exempt income, and thus would increase basis in the member's stock by that amount (other than stock of the common parent). Generally, this would have the effect of increasing basis in subsidiary stock by the amount of FDII and GILTI without regard to the Section 250 deduction.

Application to tax-exempt corporations

A US corporation that is subject to the unrelated business income tax under Section 511 may claim a Section 250 deduction. The Proposed Regulations would clarify that such corporation's FDII is determined only with respect to the items of income, gain, deduction or loss, and adjusted bases in property that are taken into account in computing unrelated business income.

Reporting considerations

The Proposed Regulations would require any taxpayer claiming a deduction under Section 250 to file new Form 8993, *Section 250 Deduction for Foreign-Derived Intangible Income (FDII and Global Intangible Low-Taxed Income (GILTI)*, with the taxpayer's annual income tax return. In addition, the Proposed Regulations would also require taxpayers that must file Forms 5471, 5472 and 8865 to include certain information related to the Section 250 deduction when information otherwise required to be reported on the form affects the filer's Section 250 deduction.

Effective date

The proposed regulations under Section 250 would apply to tax years ending on or after 4 March 2019. For tax years before that date, the Proposed Regulations provide that taxpayers may use any reasonable documentation maintained in the ordinary course of business, provided the documentation meets the reliability requirements.

The proposed regulations under Section 962 would apply to a foreign corporation's last tax year ending on or after 4 March 2019 and to the tax year of the domestic person in which or with which such tax year of the foreign corporation ends.

The proposed regulations under Section 1502 would apply to consolidated return years ending on or after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register. Taxpayers may, however, rely on the Prop. Reg. 1.1502-50 before that date.

Implications

The Proposed Regulations restate and confirm much of what is in Section 250, but, more importantly, provide helpful guidance for many open questions not addressed clearly by the statute, the most important of which is how to determine foreign use. It's not surprising the Proposed Regulations require extensive documentation to prove foreign use, which is perhaps simply a compliance exercise, although obtaining documentation could be difficult in business-to-consumer transactions. For general services, identifying the benefit conferred upon a business recipient's US and non-US operations may prove a challenging exercise in many cases.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. See EY Global Tax Alert, *US proposed GILTI regulations implement international tax reform changes*, dated 17 September 2018.
3. Under the statute the deduction allowed with respect to a Section 78 GILTI dividend is not affected by this taxable income limitation.

4 Special rules apply to sales of property or services provided to related persons or domestic intermediaries.

5 The Proposed Regulations specifically state that sales of securities or certain commodities do not qualify as FDDEI sales because, as noted in the Preamble, such sales cannot be for a foreign use.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services

- Craig Hillier, *Boston* craig.hillier@ey.com
- Jose Murillo, *Washington, DC* jose.murillo@ey.com
- Peter Marrs, *New York* peter.marrs@ey.com
- Megan Hickman, *Washington, DC* megan.hickman1@ey.com

Ernst & Young LLP, Transaction Advisory Services

- Donald Bakke, *Washington, DC* donald.bakke@ey.com
- Andrew Herman, *Washington, DC* andrew.herman1@ey.com

International Tax Services

Global ITS Leader, **Jeffrey Michalak,** *Detroit*

ITS Director, Americas, **Craig Hillier,** *Boston*

ITS Markets Leader, Americas, **Stephen O'Neil,** *New York*

National ITS Leader, **Jose Murillo,** *Washington*

ITS Regional Contacts, Ernst & Young LLP (US)

Central
Colleen Warner, *Chicago*

Northeast
Jonny Lindroos, *McLean, VA*

Southeast
Scott Shell, *Charlotte, NC*

Southwest
Amy Ritchie, *Austin*

West
Sadler Nelson, *San Jose, CA*

Financial Services
Chris J Housman, *New York*

Canada - Ernst & Young LLP (Canada)
Albert Anelli, *Montreal*

EY | Assurance | Tax | Transactions | Advisory

EYG no. 000757-19Gbl

1508-1600216 NY
ED None

ey.com