

## US Proposed Section 250 regulations on GILTI/FDII deduction have implications for partnerships, S corporations, trusts, and individual owners of CFCs

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### Executive summary

Though primarily focused on corporations, recently proposed regulations (the [Proposed Regulations](#)) on the Internal Revenue Code<sup>1</sup> Section 250 deduction for global intangible low-taxed income (GILTI) and foreign-derived intangible income (FDII) also affect pass-through entities, trusts and individuals. This Tax Alert provides an overview of the Proposed Regulations for taxpayers that recognize GILTI or foreign-derived deduction-eligible income (FDDEI) both through foreign and domestic pass-through entities and as individuals. It also addresses the Proposed Regulations issued under Section 962 and highlights some of the issues associated with that election in the context of the *Tax Cuts and Jobs Act* (TCJA).

A detailed discussion of provisions of the Proposed Regulations not covered in this Alert can be found in EY 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](#), dated 12 March 2019. See EY Global Tax Alert, [US proposed GILTI regulations implement international tax reform changes](#), dated 17 September 2018 for an additional discussion of GILTI and the proposed regulations under Section 951A.

## Detailed discussion

### Summary of GILTI and FDII

Before the TCJA, United States (US) Shareholders (within the meaning of Section 951(b)) of a controlled foreign corporation (CFC) (within the meaning of Section 957(c)), were taxed on their pro rata share of a CFC's subpart F income (generally, certain passive income and income derived through certain related-party transactions), but were generally not subject to current US federal income taxation on undistributed active CFC income. Under new Section 951A, a US shareholder of a CFC must include in gross income its pro rata share of the CFC's net tested income. Net tested income is generally defined as the gross income of a CFC less certain statutory exceptions and deductions (including taxes) properly allocable to tested income.<sup>2</sup>

The TCJA also introduced a statutory deduction under new Section 250, which provides domestic corporations with (i) a 37.5% deduction for any FDII; and (ii) a 50% deduction for any GILTI income, plus the amount treated as a dividend under Section 78 with respect to foreign tax credits allocable to such GILTI income. Unlike the full 21% corporate tax rate applied to subpart F income, the Section 250 deduction results in a domestic corporation paying an effective US federal tax rate of 13.125% on its FDDEI and a 10.5% effective corporate tax rate on its GILTI inclusion, before claiming any available foreign tax credits.

Generally, the deduction for FDII is available only for deemed intangible income that domestic corporation derives from selling products or providing services to unrelated foreign persons when that product or service is for foreign-use by the customer. Section 250(b)(3) defines a domestic corporation's deduction-eligible income as gross income, determined without regard to: (i) subpart F income, (ii) GILTI, (iii) financial services income, (iv) dividends received from CFCs, (v) domestic oil and gas income; and (vi) foreign branch income, less allocable deductions.

### Proposed Treas. Reg. Section 1.250(a)-1: Deductions for GILTI and FDII

Generally, the Proposed Regulations mirror the statute, which allows a domestic corporation a deduction, for any tax year, equal to the sum of (i) 37.5% of its FDII for the year; and (ii) 50% of (A) its GILTI for the year; and (B) the amount treated as a dividend received by a corporation

under Section 78 that is attributable to its GILTI for the year. The deduction percentages decrease to 21.875% and 37.5%, respectively, for tax years beginning after 31 December 2025. See Section 250(a)(3) and Prop. Reg. Section 1.250(a)-1(b)(3).

Under the statute, Section 250 is effective for tax years beginning after 31 December 2017. The Proposed Regulations, however, would apply Proposed Reg. Section 1.250(a)-1 through 1.250(b)-6 to tax years ending on or after 5 March 2019. For tax years beginning on or before 5 March 2019, Treasury permits taxpayers to use any reasonable documentation maintained in the ordinary course of their business to establish a recipient's foreign residence/location and foreign use of property, provided the documentation meets the reliability requirements described in Reg. Section 1.250(b)-3(d). The Preamble also clarifies that taxpayers may rely on Proposed Reg. Sections 1.250(a)-1 through 1.250(b)-6 and Section 1.962-1(b)(1)(i)(B)(3) for tax years ending before 5 March 2019.

Section 250(b) limits deductions when the domestic shareholder's GILTI and FDII exceed its taxable income (without taking into account the Section 250 deduction). If the sum of the GILTI and FDII Section 250 deductions exceeds the corporation's tax income, then the GILTI and FDII deductions decrease proportionately by the excess. The Proposed Regulations further clarify that the excess of the sum of the taxpayer's FDII and GILTI over the corporation's taxable income both are computed without regard to the Section 250 deduction but should take into account application of Sections 163(j) and 172(a). The Proposed Regulations provide a multi-step process for coordinating the sequence of computations under Sections 163(j), 172 and 250 (illustrated by an example), to avoid circularity in the computations.

The Proposed Regulations confirm that the term "domestic corporation" is defined with reference to Section 7701(a) and explicitly excludes S corporations. That is, an S corporation is not eligible to claim the Section 250 deduction.

#### Key takeaway:

- Generally, only domestic C corporations (not S corporations or partnerships) can claim the GILTI and FDII deductions provided under Section 250 in computing US taxable income. See the later discussion, however, on the availability of the Section 250 deduction for individuals and trusts making Section 962 elections.

## Proposed Treas. Reg. Section 1.250(b)-1: Computation of FDII

Generally, a domestic corporation's foreign-derived intangible income is the product of multiplying (i) the ratio of foreign-derived deduction-eligible income (FDDEI) to total deduction-eligible income (DEI), by (ii) the corporation's deemed intangible income. Section 250 and the Proposed Regulations define a corporation's deemed intangible income for its tax year as the excess of the corporation's DEI over the corporation's deemed tangible income return (DTIR). Like the GILTI provisions under Section 951A, the Proposed Regulations define a domestic corporation's DTIR as 10% of the corporation's qualified business asset investment (QBAI) for the year. For FDII, a corporation's QBAI is only the specified tangible property that produces DEI.

As described previously, Section 250(b)(3) defines a domestic corporation's deduction-eligible income as gross income, determined without regard to: (i) subpart F income, (ii) GILTI, (iii) financial services income, (iv) dividends received from CFCs, (v) domestic oil and gas income, and (vi) foreign branch income, less allocable deductions.

While the Proposed Regulations provide details and examples relevant to FDDEI from sales, services, and related party transactions, the later analysis focuses on distinctions relevant to private companies, and pass-through entities.<sup>3</sup>

Proposed Treas. Reg. Section 1.250(b)-1(c)(11) defines foreign branch income as gross income attributable to a foreign branch of a domestic corporation or a partnership under Proposed Treas. Reg. Section 1.904-4(f)(2). The Proposed Regulations also include any income or gain that would not be treated as gross income attributable to a foreign branch under Reg. Section 1.904-4(f) but that arises from the 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 DRE or interest in a partnership.

The Proposed Regulations clarify that, for purposes of determining whether a sale of property to or by a partnership or a provision of service to or by a partnership is a FDDEI transaction, a partnership is treated as an entity, rather than as an aggregate of its partners. Therefore, income from a sale to a foreign partnership may qualify as FDDEI assuming other requirements are met, whereas a sale to a domestic partnership does not qualify.

## Domestic corporate partners

Under the Proposed Regulations, a domestic corporation would determine deduction-eligible income (DEI) and FDDEI for a tax year by taking into account the corporation's share of gross DEI, gross FDDEI and deductions of any partnership (*whether domestic or foreign*) in which the corporation is a direct or indirect partner. A domestic corporation's share of each such item of a partnership would be determined in accordance with the corporation's distributive share of the underlying items of income, gain, deduction and loss of the partnership that comprise those amounts. Proposed Treas. Reg. Section 1.250(b)-2(g) provides similar rules for calculating the increase to a domestic corporation's QBAI by the corporation's share of partnership QBAI.

To facilitate a domestic corporate partner's FDII deduction, Proposed Treas. Reg. Section 1.250(b)-1(e)(2) provides information-reporting requirements for partnerships with domestic corporate partners. Under the Proposed Regulations, the deadline for furnishing direct or indirect corporate partners with their share of the partnership's gross DEI and gross FDDEI would be the due date (including extensions) for furnishing the partner's Schedule K-1. The same deadline would apply for furnishing amounts of partnership QBAI for each tax year in which the partnership has DEI, gross DEI, deductions definitely related to such amounts, or partnership tangible property,

The Proposed Regulations do not provide direct guidance on the amounts to deduct for calendar-year corporations that are partners in partnerships whose tax year began before the effective date of Section 250 but ends during the domestic corporation's first tax year beginning after 31 December 2017. As previously discussed, the Proposed Regulations, and Treasury's explanation in the Preamble, may apply to tax years beginning before 4 March 2019.

### Key takeaways:

- ▶ *Domestic corporations recognizing either GILTI or FDII through a partnership should be permitted to claim the Section 250 deduction for those amounts.*
- ▶ *General US federal income tax principles under subchapter K likely allow a corporate partner to claim its allocable share of the full amount of a partnership's DEI, FDDEI, deductions, and partnership QBAI for the partnership's tax year ending with or within the corporation's tax year ending before 4 March 2019.*

- *Partnerships must furnish the relevant FDII information to their domestic corporate partners by the due date for the information return including, the partners' share of deduction-eligible income, foreign-derived deduction-eligible income and partnership QBAI.*

### **Proposed Treas. Reg. Section 1.250(b)-2: Partnership QBAI**

Like Treasury's proposed Section 951A regulations, the Proposed Regulations provide that the QBAI of a domestic corporation with an interest in one or more partnerships at the close of its tax year increases by the sum of the domestic corporation's partnership QBAI with respect to each partnership in which the corporation is a partner during its tax year.

The term "partnership QBAI" means the domestic corporation's share of the partnership's adjusted basis in the partnership's specified tangible property that produced DEI during the tax year, measured as of the close of a partnership tax year that ends with or within a domestic corporation's tax year. The Proposed Regulations would require a domestic corporation's share of the partnership's adjusted basis in partnership specified tangible property to be determined separately for each partnership specified tangible property by multiplying the partnership's adjusted basis in the property by the partnership QBAI ratio for the property. The adjusted basis in specified tangible property would be determined under US tax principals and reflect the Alternative Depreciation System (ADS) under Section 168(g). See Proposed Treas. Reg. Sections 1.250(b)-2(e)(1) and 1.250(b)-2(g)(iii).

The Proposed Regulations provide anti-avoidance rules that disregard certain transfers of property when determining a domestic corporation's QBAI.<sup>4</sup>

### **Proposed. Treas. Reg. Section 1.962-1: Election by individuals to be subject to tax at corporate rates**

Introduced with the Internal Revenue Code of 1954, Section 962 permits an individual (including a trust or estate) who is a US shareholder of a CFC to make an annual election to be taxed on subpart F income at corporate income tax rates under Section 11 and to claim deemed paid foreign tax credits under Section 960. Section 951A(f)(1)(A) extended the availability of the Section 962 election to an individual's GILTI inclusions. The purpose of Section 962, as expressed

in the Congressional record, is to create parity between those individuals who own foreign investments directly with those who own foreign investments through a domestic corporation.

Eligibility to make a Section 962 election does not require the electing individual to own CFC stock directly, but rather permits the election with respect to any CFC for which the individual is a US shareholder, as defined in Section 958, directly, indirectly or by attribution through a domestic pass-through entity.

If an election is made under Section 962, the amounts included in the individual's gross income under Section 951(a) are treated as if they were received by a domestic corporation. Current Treas. Reg. Section 1.962-1(b)(1)(i), however, explicitly denies any shareholder deductions to reduce amounts subject to the benefits of the election even though those deductions would be available to an actual C corporation. Until the release of the Proposed Regulations, it has been unclear whether an individual who made a Section 962 election could claim the Section 250 deduction to offset any GILTI inclusion.

The Proposed Regulations would amend Treas. Reg. Section 1.962-1(b)(1)(i)(A)(2) to explicitly permit an electing individual to claim the Section 250 deduction for GILTI inclusions. In describing the change, the IRS and Treasury refer to Congress's original intent in enacting Section 962 as well as the economic benefit derived from restoring the parity between direct investors and those investing through domestic corporations.

Proposed Treas. Reg. Section 1.250(d) would impose an annual reporting requirement on domestic corporations and individuals making an election under Section 962 who claim a deduction under Section 250 for the tax year. In addition to Form 8892, *US Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, which is required for taxpayers reporting a GILTI inclusion, those taxpayers claiming the deductions permitted by Section 250 must also complete Form 8993, *Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)*, with such taxpayer's income tax return filed on or before the due date of the relevant return (taking into account extensions).

The Proposed Regulations would apply the Section 250 deduction permitted for a Section 962 election to (i) a foreign corporation's tax years ending on or after 4 March 2019, and (ii) a US person's tax year ending in or with the foreign

corporation's tax year. Nevertheless, the general applicability date for Proposed Treas. Reg. Section 1.962-1(b)(1)(i), identifying GILTI exclusions, would be the last tax year of a foreign corporation that begins before 1 January 2018; for a United States person, it would be the tax year in which or with which the tax year of the foreign corporation ends. The Preamble to the Proposed Regulations identifies Proposed Treas. Reg. Section 1.962-1(b)(1)(i)(B)(3), as proposing to apply to tax years of a foreign corporation ending on or after 4 March 2019.

**Key takeaways:**

► *The Proposed Regulations provide welcome relief to individuals who will have GILTI by allowing them to claim the Section 250 deduction against that income without having to interpose a C corporation between themselves and the CFC.*

- *Before making the Section 962 election or altering their ownership structure, individuals should model the consequences of using a C corporation versus making annual Section 962 elections. Although the federal tax treatment may be similar in some cases, state income tax and other consequences could vary between these two choices.*
- *Due to the apparent conflict between the effective date of Proposed Treas. Reg. Section 1.962-1(b)(1)(i) as described in the Preamble versus the text of the Proposed Treas. Reg. Section 1.962-1(d), uncertainty exists as to whether the Section 250 deduction applies to individuals with GILTI inclusions for the tax year of a CFC that began on or after 1 January 2018 and ends on or before 5 March 2019.*

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## 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 for a detailed discussion of the proposed regulations under Section 951A.
3. For a more comprehensive review of the computations and definitions promulgated by the Proposed Regulations, refer to EY 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](#), dated 12 March 2019.
4. See the discussion of Proposed Treas. Reg. Section 1.250(b)-2(h) in EY 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](#), dated 12 March 2019.

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