Final FDII/GILTI Regulations Withdraw Deduction Ordering Rule

July 20, 2020

Domestic corporations that earn foreign-derived intangible income ("FDII") or global intangible low-taxed income ("GILTI") should be aware that final regulations published on July 15, 2020 (the "Final Regulations"), liberalized the rules for computing the section 250 deduction for GILTI and FDII. For well-advised taxpayers, the change generally will increase the section 250 deduction available to domestic corporations that have significant interest expense or net operating losses ("NOLs") by permitting greater electivity in how they compute these deductions on their return.

Statutory Background

Section 250 provides a deduction that implements the preferential rates for GILTI and FDII granted by the Tax Cuts and Jobs Act ("TCJA"). Very generally, section 250 currently entitles a domestic corporation to deduct 50% of its GILTI, and 37.5% of its FDII. Section 250 limits the amount against which the deduction may be claimed to the domestic corporation's "taxable income" as determined before the section 250 deduction.

The taxable income limitation creates computational conundrums because the TCJA also imposed taxable income limitations on other deductions that must be taken into account under section 250. Following the TCJA and amendments made in the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"):

- Section 163(j) generally limits the deduction for net business interest expense to 30% of the taxpayer's adjusted taxable income, net of the section 250 deduction but prior to the section 172 deduction. For 2019 and 2020, taxpayers are permitted to elect to deduct up to 50% of their adjusted taxable income.

- Section 172 limits the deduction of NOL carryforwards arising from post-TCJA tax years to 80% of the taxpayer's taxable income, net of the section 163 deduction but prior to the section 250 deduction, effective beginning in 2021. Pre-TCJA year NOLs will not be restricted in this manner.

Moreover, a taxpayer's section 250 deduction depends on its FDII, which in turn depends on the allocation and apportionment of the section 163 and 172 deductions against eligible income.

The TCJA itself did not provide an ordering rule coordinating these limitations. Thus, the Code does not clarify whether the limitation on the section 250 deduction is based on taxable income determined before or after applying the interest expense limitation under section 163(j) or the NOL limitation under section 172, or whether the deductions allowed under sections 250, 163 and 172 are computed together using simultaneous equations.

This uncertainty is important, because the methodology used to coordinate the section 250, 163 and 172 deductions can affect both a corporation's bottom-line taxable income and the amount of the allowance under each section. The significance is compounded by the fact that unused section 250 deductions do not carry over, whereas unused section 163(j) limitations and 172 deductions are suspended or carried forward and remain potentially usable in future taxable years. As a result, if the method produces similar bottom-line taxable income with a larger section 163 or 172 deduction and a smaller section 250 deduction, the method will consume valuable net interest expense and NOL attributes with no offsetting benefit.

Proposed Regulations

Proposed regulations published on March 6, 2019 (the "Proposed Regulations") attempted to resolve this ambiguity by setting forth an iterative calculation that is intended to approximate the outcome that would result if taxable income were computed through simultaneous equations, without in fact requiring the use of simultaneous equations. Treasury and the IRS were concerned that simultaneous equations would not be administrable, but some taxpayers and their advisors advocated that they should be permitted, as they are consistent with the Code and their use may reduce a corporation's taxable income and preserve valuable tax attributes.

Treasury's proposed method has been described as an "ordering rule" because it does not require simultaneous equations, but it is intended to incorporate elements of simultaneity by taking the section 250 deduction into account both before and after the section 163(j) limitation and 172 deduction (first on a tentative and then on an actual basis). Due to this feature, the effects of using the Proposed Regulations' approach typically will depend on whether the tentative section 250 deduction is larger, or smaller, than the section 250 deduction calculated via simultaneous equations. This in turn typically will depend on interactions between a corporation's FDII-eligible income, interest expense disallowance and NOLs for the year.

The Final Regulations

The Final Regulations withdraw the ordering rule of the proposed regulation and reserve on this issue pending further study. The regulations go on to provide that in the absence of guidance a taxpayer may use any reasonable method to compute its section 250 limitation if the method is applied consistently for all taxable years beginning on or after January 1, 2021. The preamble clarifies that a reasonable method includes either simultaneous equations or the Proposed Regulations' ordering rule. The Proposed Regulations had anticipated statutory changes later made in the CARES Act, and thus the proposed ordering rule should remain permissible without change.

The any-reasonable-method rule leaves open the possibility that the taxpayer may adopt their own method, which may be attractive to some taxpayers if the method makes it easier to reason about the numbers they should expect at year-end. Corporations should anticipate, however, that a reasonable alternative will need to incorporate iterative elements such as those in the Proposed Regulations, which are likely to make it difficult to intuit the most advantageous result. Additionally, a reasonable alternative method must take into account all the variables required under the statute, including the allocations required when computing FDII. The possible guidance project envisioned in the preamble to the Final Regulations may prohibit or solidify alternative methods by ruling or notice as Treasury and the IRS gain more experience with taxpayer's compliance practices.

A corporation considering the effect of these rules should review the alternatives and adopt a method that it expects to be most beneficial in view of its current and expected tax profile, and should be prepared to apply the method consistently from year to year. The consistency requirement applies only with respect to taxable years beginning on or after January 1, 2021, when the CARES Act modifications generally cease to apply and section 163(j) and 172 largely revert to the form in which they were enacted in the TCJA. Corporations are therefore free to file or amend returns for pre-2021 tax years using the method that maximizes the benefit to them, without regard to the method that may be optimal in the future. However, corporations that devise their own reasonable method should proceed with caution, as future inconsistency arising from reasons other than the sunset of CARES Act provisions may attract increased scrutiny from the IRS.

Attorneys in Caplin & Drysdale's International Tax practice group are here to help with any questions, including advice on the benefits or drawbacks of adopting a consistent method of taking taxable income limitation into account in their particular situation.

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