Bloomberg Tax

Tax Management
International Journal™

October 18, 2024

IRS Sends Statutory Frankenstein to Take Your §250 Deductions

John Barlow, Ethan Kroll, and Sam Pollack*
Baker McKenzie

The IRS has staked out its position on §246(b) disallowing some of a taxpayer's FDII and GILTI deductions in GLAM 2024-002, but the statute is poorly drafted and courts will need to weigh in to resolve open issues, say Baker McKenzie practitioners.

GLAM 2024-002 introduces the IRS's position that it may use §246(b) to disallow some of a taxpayer's §250 deductions (i.e., FDII and GILTI deductions) during years in which the taxpayer has profitable foreign operations but otherwise unprofitable US operations. Some taxpayers are already beginning to explore options to combat the GLAM's interpretation of §246(b).

Before the GLAM was issued, many taxpayers thought that their §250 deductions would only be disallowed under §250(a)(2)—i.e., to the extent that the taxpayer's combined GILTI and FDII inclusions exceeded its taxable income. They did not think that a provision in a section titled, "rules applying to deductions for dividends received," would be interpreted to reduce a §250 deduction (*See* §246). Thus, these taxpayers are likely to be shocked to learn that the IRS intends to apply the Frankenstein provision that is §246(b) to disallow §250 deductions.

At a high-level, we expect that the GLAM's conclusion will primarily impact taxpayers with material US losses and GILTI inclusions, including in open COVID years. That being said, it is not clear that the GLAM will have a significant impact in post-2025 years, assuming that the §250 deductions for GILTI and FDII are reduced in 2026. Finally, some taxpayers that have large domestic dividends received deductions (DRD) may benefit from the GLAM's conclusion (depending on their facts).

The GLAM's Interpretation of §246(b)

The GLAM reaches its conclusion by interpreting §246(b), as amended by the TCJA, to disallow §250 deductions in certain circumstances.

Historically, §246(b) has limited the DRD that a US corporation can claim for certain dividends. Before the TCJA, former §246(b)(1) provided that "the aggregate amount of the deductions allowed by [§243 and §245] shall not exceed the percentage determined under [§246(b)(3)] of the taxable income [subject to certain adjustments]."

The limitations in former §246(b)(3) then provided that the percentage limitation of taxable income was based on the type of dividends that the taxpayer had received during the year. Specifically, former §246(b)(3) provided that, "with respect to dividends from 20-percent corporations," the taxable income limitation percentage was based on the 80% DRD rate under former §243(a)(1), and that, "with

* John Barlow is a partner in Baker McKenzie LLP's Washington, D.C. office. Ethan Kroll is a partner in the Los Angeles office. Sam Pollack is a partner in the Chicago office.

respect to dividends not from 20-percent owned corporations," the taxable income limitation percentage was based on the 70% DRD rate under former §243(c)(1).

In 2017, the TCJA confusingly added §250 deductions to the list of deductions that are aggregated under §246(b), even though §246 remains titled, "rules applying to deductions for dividends received." As a result, current §246(b)(1) now provides, with relevant changes underlined:
"[T]he aggregate amount of the deductions allowed by [§243, §245,] and section 250 shall not exceed the percentage determined under [§246(b)(3)] of the taxable income computed without regard to the deductions allowed by sections 172, 199A, 243(a)(1), [245], and 250 [and certain other adjustments]."
The remainder of this article refers to §246(b)(1)'s taxable income determined without regard to §172, §199A, §243, §245, and §250 deductions (as well as other deductions) as "Pre-NOL/250 Taxable Income."

The TCJA, however, did not modify §246(b)(3), except to reduce the limitation percentages so that the taxable income limitation percentages maintained parity with the TCJA's amended DRD rates for 20-percent and non-20-percent owned domestic corporations (i.e., the rates were reduced from 80% and 70% to 65% and 50%, respectively). Thus, current §246(b)(3) does not indicate how taxpayers can even determine taxable income limitations "with respect to" non-dividend GILTI and FDII items.

Taken together, the TCJA's jumbled changes to §246(b) create a Frankenstein statute that has confused taxpayers since 2017. Nevertheless, the GLAM says it is "clear" that Frankenstein §246(b) limits a taxpayer's §250 deductions, in addition to limiting its DRDs. The GLAM maintains that the hook for its conclusion is the statutory language in §246(b)(1), which, as quoted above, states that the aggregate §243, §245, and §250 deductions "shall not exceed" the percentage determined in §246(b)(3). The GLAM, however, does not address §246(b)(3)'s inapplicability to non-dividend items. Instead, the GLAM says that a taxpayer must limit its §250 deductions based on the lower of the taxpayer's Pre-NOL/250 Taxable Income multiplied by both of the new 65% and 50% DRD rates in amended §246(b)(3). Obviously, taxpayers will normally be limited by the 50% threshold. The GLAM's application of §246(b)(3) to GILTI and FDII is the most questionable part of the GLAM.

Most importantly, the IRS interprets this language to provide that §246(b)(3) operates in respect of §250 deductions even when the taxpayer does not receive any dividend that is eligible for the §243 or §245 DRD (See Scenario 1 in the GLAM).

The consequence of the GLAM applying a §246(b) limitation in the absence of a DRD is that the GLAM effectively interprets §246(b) as limiting §250 deductions that are attributable to the §78 gross-up amount. This result is notable for two reasons. First, the GLAM reaches its conclusion despite taking the position that a §78 gross-up is not a dividend. Second, the §250(a)(2) limitation does not take the §78 gross-up into account. Specifically, while §250(a)(1)(B)(ii) provides that the §78 gross-up with respect to GILTI gives rise to a §250 deduction, §250(a)(2)(A)(i) only takes into account FDII and GILTI income when determining the §250(a)(2) limitation.

Thus, the GLAM provides something of a back door to apply a limitation to the §250 deduction that is attributable to the §78 gross-up, as illustrated in the GLAM's Scenario 1. The illustration involves a domestic corporation that has a $200x GILTI inclusion, a $20x §78 gross-up with respect to GILTI, and $10x of deductions not related to GILTI (and, presumably, no other items of income, gain, deduction or loss). Under these facts, the §250(a)(2) limitation does not apply because GILTI plus FDII ($200x) is not greater than taxable income (without the §250 deductions), $210x ($200x + $20x - $10x). However,

the §246(b) limitation, as interpreted by the GLAM, applies because the US corporation's §250 deduction of $110x ($100x for GILTI and $10x for the related §78 gross-up) is greater than 50% of the corporation's Pre-NOL/250 Taxable Income, $105x (50% of $210x). If the taxpayer in Scenario 1 had no foreign tax credits and thus no §78-gross-up, then there would have been no §246(b) limitation because §250(a)(2) would have already haircut the §250 deduction attributable to the GILTI by $5x. (Of course in this hypothetical with no foreign tax credits, the taxpayer would also have $10x less of income because the taxpayer would not have a $10x §78 gross-up, unlike the taxpayer in Scenario 1.)

In the less common circumstance where a taxpayer recognizes FDII/GILTI and receives one or more dividends that benefit from DRDs under §243 or §245, the GLAM provides complex ordering rules for determining whether and how the §246(b) limitation applies to reduce the DRDs and the §250 deductions.

All told, the GLAM has given a jolt of electricity to the agglomeration that is §246(b), and §246(b) is now very much alive for taxpayers.

Which Taxpayers Are Impacted by the GLAM?

Taxpayers need to be aware that IRS examination teams may apply the deduction limitation in §246(b) in addition to testing whether the limitation in §250(a)(2) applies.

As we note above, we suspect that a taxpayer is most likely to be affected by the GLAM if it has a GILTI inclusion but otherwise has unprofitable US operations (e.g., its US losses are offsetting its GILTI and §78 gross-up). In such a case, the taxpayer's §250 deductions are generally limited to somewhere around 50% of the taxpayer's Pre-NOL/250 Taxable Income for that taxable year (the calculations can be complex!). Specifically, the GLAM will often effectively apply to limit the amount of the §250 deduction that is attributable to the §78 gross-up.

Generally speaking, we observe that a taxpayer with high-taxed CFCs and no §243/245 DRDs will need to model whether the loss of the §250 deduction (which will no longer reduce the taxpayer's GILTI foreign tax credit limitation) will in fact result in additional US tax. In addition, the GLAM's conclusions may be helpful to taxpayers with high-tax GILTI that receive dividends that give rise to §243 or §245 DRDs that are subject to the §246(b) limitation. For such taxpayers, the GLAM acknowledges that a portion of the §246(b) limitation is allocated to reduce the taxpayer's §250 GILTI deduction, which thereby increases GILTI basket foreign tax credit limitation, and, at the same time, does not reduce the amount of the §243/245 DRD.

Does §246 Limit §250 Deductions?

As we indicate above, the GLAM's conclusion is based on the argument that the plain language of the §246(b)(1) limitation can also apply to deductions that are not DRDs. However, taxpayers may point out that §246 is titled, "rules applying to deductions for dividends received," and a §250 deduction is not a deduction for dividends received.

Most importantly, taxpayers will also point out that the limitation in §246(b)(1) is determined based on the provisions in §246(b)(3). Section 246(b)(3) only provides percentage limitations "with respect to dividends from 20-percent owned corporations" and "with respect to dividends not from 20-percent owned corporations," and those percentage limitations are based on rates specific to the DRDs in §243 and §245. Section 246(b)(3) does not contain a rule with respect to items attributable

to §250 deductions, and the GLAM does not address this statutory silence. Moreover, the GLAM seems to avoid characterizing any portion of a §250 deduction as a deduction with respect to a dividend under §78 or treating GILTI from wholly-owned CFCs as dividends from 20-percent owned corporations.

Instead, the GLAM provides that both DRD rates in §246(b)(3) are relevant for purposes of §250 deductions, and taxpayers need to apply the limitation that produces the most taxpayer unfavorable answer.

Finally, the policy reasons addressed in the GLAM may also leave some taxpayers scratching their heads. The GLAM's first policy justification is that Congress found it inappropriate to allow taxpayers to use domestic deductions to offset GILTI and FDII income. However, taxpayers will rightfully feel whipsawed by such a justification in light of the fact that taxpayers are required to reduce their GILTI foreign tax credit limitation by some of these domestic expenses. The GLAM also provides a second policy justification based on the need to limit taxpayers' ability to use GILTI and FDII inclusions to increase §243 and §245 DRD capacity. However, this policy provides no justification for the result in Scenario 1 where the taxpayer had no DRDs and the GLAM nevertheless limits the taxpayer's §250 deductions.

Unfortunately, Congress drafted a Frankenstein statute when it amended §246(b) as part of the TCJA, and anyone trying to discern the meaning of §246(b) will quickly conclude that §246(b) is a broken statute.

Conclusion

Put simply, §246(b) is a poorly drafted statute. While the GLAM shows that the IRS has finally staked out its position on the matter, it will likely be up to the courts to decide how this monster show is resolved.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.