A NOTE FROM THE

EDITOR-IN-CHIEF

A Reminder from the IRS that Code Sec. 246(b) Can Limit Your Code Sec. 250 Deduction

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United States shareholders ("U.S. shareholders") of controlled foreign corporations ("CFCs") are generally well aware that the Code Sec. 250(a) deduction for global intangible low-taxed income ("GILTI") and foreign-derived intangible income ("FDII") is limited under Code Sec. 250(a)(2) based on the U.S. shareholder's taxable income. In particular, the Code Sec. 250(a) deduction will be limited to the extent that GILTI and FDII exceed taxable income, which would be the case if there were a loss in taxable income before taking into account GILTI and FDII. Less well known is that Code Sec. 246(b) contains another potential limitation on the Code Sec. 250 deduction and may apply even in instances where the Code Sec. 250(a)(2) deduction does not result in a limitation of the Code Sec. 250(a) deduction.

Code Sec. 246(b) has a long history in the Code. Although its statutory language is hard to parse, it generally functions to reduce the dividends received deductions ("DRDs") under Code Secs. 243(a)(1) and 245(a) and (b) to the extent that the dividend income is offset by an excess of deductions over non-dividend income. The effect of Code Sec. 246(b) is that such unrelated deductions do not reduce the effective tax rate on dividends below the deduction rate specified in Code Secs. 243 and 245. With the introduction of the Code Sec. 250 deduction as part of the Tax Cuts and Jobs Act of 2017 ("TCJA"), Code Sec. 246(b) was amended to reference Code Sec. 250, in addition to Code Secs. 243 and 245. Limiting the Code Sec. 250 deduction by way of Code Sec. 246(b) has the primary effect of preventing a GILTI inclusion from increasing the Code Sec. 246(b) taxable income limitation in a way that allows a greater Code Sec. 243(a)(1) or 245(a) or (b) DRD than would be available without a GILTI inclusion. However, as discussed below, it can also incrementally limit the Code Sec. 250 deduction in cases where there is no Code Sec. 243 or Code Sec. 245 DRD in play.

Recent guidance from the Internal Revenue Service ("IRS") in GLAM 2024-002 highlights the application of Code Sec. 246(b) to the Code Sec. 250 deduction. GLAM 2024-002 discusses the policy rationale for the relationship between Code Secs. 246(b) and 250 and clarifies an ambiguity in the application of Code Sec. 246(b) with respect to the Code Sec. 250 deduction arising from the statutory language. This column takes the GLAM as an opportunity to explain the complicated interaction between Code Secs. 246(b) and 250 that may not have been front of mind for many taxpayers.

Code Sec. 246(b) and the Code's DRD Regime

Code Sec. 243(a)(1) provides a 50-percent DRD for dividends received by a corporation from a domestic corporation of which it owns less than 20 percent of the stock and provides a 65-percent DRD for dividends from a domestic corporation where the recipient corporation owns 20 percent or more of the distributing corporation's stock by vote and value (a "20-percent owned corporation").[1] Code Sec. 245(a) allows an analogous deduction, at the same deduction percentages and ownership percentages, for the U.S.-source portion of a dividend received from a qualified 10-percent owned foreign corporation, which is defined in Code Sec. 245(a)(2) as any foreign corporation (other than a passive foreign investment company) if at least 10 percent of the stock of such corporation (by vote and value) is owned by the taxpayer. Code Sec. 245(b) allows a 100-percent DRD for dividends received by a domestic corporation from a foreign corporation that earns exclusively gross income that is effectively connected with the conduct of a trade or business with the United States.

As discussed above, Code Sec. 246(b) limits the Code Sec. 243(a)(1) and 245 DRDs (collectively, the "Limited DRDs"), as well as the Code Sec. 250 deduction. The general rule of Code Sec. 246(b)(1) provides that "the aggregate amount of deductions allowed by [the Limited DRDs] and Code Sec. 250 shall not exceed" a percentage of taxable income computed without regard to certain deductions and adjustments. In particular, the Code Sec. 246(b) ceiling is determined based on taxable income computed without regard to the Limited DRDs or Code Sec. 250, as well as without regard to Code Sec. 172 or 199A, adjustments under Code Sec. 1059, and capital loss carrybacks under Code Sec. 1212 ("Code Sec. 246(b) Taxable Income").

Under Code Sec. 246(b)(3), the limitation in Code Sec. 246(b)(1) applies separately with respect to "dividends from 20-percent owned corporations" and "dividends not from 20-percent owned corporations." As applied to dividends from 20-percent owned corporations, Code Sec. 246(b)(3)(A) limits the allowable deduction to 65 percent of Code Sec. 246(b) Taxable Income. As applied to dividends not from 20-percent owned corporations, Code Sec. 246(b)(3)(B) limits the deduction to 50 percent of Code Sec. 246(b) Taxable Income and additionally provides that Code Sec. 246(b) Taxable Income shall be reduced further for this purpose by dividends from 20-percent owned corporations.

Code Sec. 246(b) does not apply to a taxable year for which there is a net operating loss determined under Code Sec. 172.[2] Accordingly, Code Sec. 246(b) will generally apply to taxpayers that have positive taxable income but would have losses but for income eligible for one of the deductions targeted by Code Sec. 246(b).

Code Sec. 246(b) Limitation on the Code Sec. 250 Deduction Under GLAM 2024-002

How Code Sec. 246(b) applies to the Code Sec. 250 deduction is not immediately obvious from the statutory language of Code Sec. 246(b). In particular, the limitation of Code Sec. 246(b) applies separately to "dividends from 20-percent owned corporations" and "dividends not from 20-percent owned corporations," but a GILTI inclusion or amount of foreign-derived deduction eligible income ("FDDEI") is not a dividend at all. A taxpayer might be forgiven for supposing that, at a minimum, Congress did not have a clear view of how Code Secs. 246(b) and 250 should interact and possibly for questioning whether Code Sec. 246(b) should apply to the Code Sec. 250 deduction at all.

In issuing GLAM 2024-002, the IRS sought to lay to rest any doubts regarding the application of Code Sec. 246(b) to the Code Sec. 250 deduction. In particular, the GLAM asserts that the full amount of the Code Sec. 250 deduction is included in the separate application of Code Sec. 246(b) to dividends from 20-percent owned corporations and dividends not from 20-percent owned corporations. The policy rationale offered for this approach is that prevents FDII and GILTI inclusions from being reduced by deductions or items other than the Code Sec. 250 deduction or, alternatively, that it prevents FDII and GILTI inclusions from neutralizing the impact of Code

Sec. 246(b) on the Limited DRDs by boosting Code Sec. 246(b) Taxable Income. (It is not clear that this policy is fully realized with respect to FDII inclusions, at least, since the deduction rate for FDII is 37.5 percent rather than 50 percent.)

An example provided in the GLAM illustrates that Code Sec. 246(b) may limit the Code Sec. 250 deduction even in a case where there are no dividends eligible for a Limited DRD. Suppose domestic corporation DC has a $200x GILTI inclusion, a $20x Code Sec. 78 gross-up, and $10x of loss before taking into account the GILTI inclusion and Code Sec. 78 gross-up. DC has a $110x Code Sec. 250(a) deduction before taking into account the Code Sec. 250(a)(2) or 246(b)(3) limitation.

The Code Sec. 250(a)(2) taxable income limitation in this case is $210x. Because $210x exceeds the $200x GILTI inclusion, the Code Sec. 250(a)(2) taxable income limitation does not reduce the GILTI deduction. Here, it is noteworthy that the Code Sec. 250(a)(2) taxable income limitation does not limit the Code Sec. 250 deduction allowed for the Code Sec. 78 gross-up. In fact, the Code Sec. 78 gross-up increases taxable income in a way that may prevent the application of the Code Sec. 250(a)(2) limitation. In the example, if there were no Code Sec. 78 gross-up, the taxable income limitation would be $190x, and GILTI would be reduced under Code Sec. 250(a)(2) from $200x to $190x. As a result, the Code Sec. 250 deduction would be reduced under Code Sec. 250(a)(2) by $5x, from $100x to $95x.

As a general matter, the Code Sec. 246(b)(3)(B) limitation for dividends not from 20-percent owned corporations will be more limiting than the Code Sec. 245(b)(3)(A) limitation for dividends from 20-percent owned corporations, since the Code Sec. 246(b)(3)(B) limitation is determined based on a lower percentage (*i.e.*, 50 percent *vs.* 65 percent) of Code Sec. 246(b) Taxable Income. In this example, the Code Sec. 246(b)(3)(B) limitation is $105x, which is 50 percent of $210x Code Sec. 246(b) Taxable Income. Thus, the potential Code Sec. 250 deduction of $110x is reduced under Code Sec. 246(b) by $5x to $105x.

Notably, were it not for the Code Sec. 78 gross-up, Code Sec. 246(b) would not have resulted in any incremental reduction in the Code Sec. 250 deduction after the application of Code Sec. 250(a)(2). In that case, Code Sec. 246(b) Taxable Income would be $190x, and the Code Sec. 246(b)(3) limitation on the Code Sec. 250 deduction would be $95x. As noted above, however, the Code Sec. 250 deduction after the application of Code Sec. 250(a)(2) already was $95x, so Code Sec. 246(b) causes no further reduction. This example highlights that when Code Sec. 246(b) applies to the Code Sec. 250 deduction, it applies because it reduces the Code Sec. 250 deduction attributable to the Code Sec. 78 gross-up, whereas Code Sec. 250(a)(2) expressly does not apply to the Code Sec. 78 gross-up.

Is This Really Necessary?

Code Sec. 246(b) mainly impacts the Code Sec. 250 deductions of taxpayers that have GILTI inclusions and have a loss in taxable income before GILTI is taken into account. As described above, it mainly applies because of a disconnect between Code Secs. 250(a)(2) and 246(b) with regard to the Code Sec. 78 gross-up. This fact alone raises the question of whether Congress fully thought through the interaction of Code Secs. 246(b) and 250, as well as the question of why Code Sec. 246(b) should apply more broadly than Code Sec. 250(a)(2). Another curiosity is that neither of the percentages in Code Sec. 246(b)(3) (50 percent and 65 percent) corresponds to the FDII deduction rate of 37.5 percent.

GLAM 2024-002 indicates that a possible policy rationale for the application of Code Sec. 246(b) to Code Sec. 250 is to prevent GILTI inclusions, for instance, from neutralizing the application of Code Sec. 246(b) limitation to a Code Sec. 243 or 245 DRD by increasing Code Sec. 246(b) Taxable Income. This explanation is plausible, but given the imprecision in the application of Code Sec. 246(b) to Code Sec. 250, Congress might consider whether there are other ways to achieve the same goal. One possibility might be to simply remove GILTI and FDII inclusions from the scope of Code Sec. 246(b) Taxable Income, along with removing the application of Code Sec. 246(b) to Code Sec. 250. This approach would protect the application of Code Sec. 246(b) to DRDs while letting Code Sec. 250(a)(2) be the sole limitation on the Code Sec. 250 deduction.

ENDNOTES

[1] Code Sec. 245(a)(3) further provides a 100-percent DRD for dividends received from a member of the same affiliated group (determined under an 80-percent ownership standard).

[2] Code Sec. 246(b)(2).