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Global View

How to Elect Code Sec. 962 Treatment: New Uses for an Old Tool?

By Robert Misey

Ever since passage of the Tax Reform Act of 2017, international tax professionals have advised U.S. individuals to consider the use of making a Code Sec. 962 election. Immediately after the Act, international tax professionals considered the election with respect to the one-time transition tax,¹ which is old news. Now, international tax professionals are considering the use of the Code Sec. 962 election to reduce the U.S. taxation of Global Intangible Low-Taxed Income (“GILTI”).²

Why Does the Code Sec. 962 Election Exist?

Congress created Code Sec. 962 in 1962 as part of the Subpart F regime that ended deferral from U.S. tax for U.S. Shareholders of certain income earned by controlled foreign corporations (“CFC”).³ If a U.S. Shareholder was a C corporation, the C corporation could avoid double taxation (taxation by both the foreign country and the United States) *via* the deemed paid foreign tax credit.⁴ However, U.S. Shareholders who were individuals could not and never could obtain a deemed paid foreign tax credit. Moreover, the outrageously-high U.S. individual tax rate in 1962 made it tax prohibitive for a U.S. individual to directly own a CFC that earned Subpart F income.

Code Sec. 962 provides an alternative tax regime for individual U.S. Shareholders of CFCs. More specifically, an individual U.S. Shareholder may elect to be taxed on her share of Subpart F income at the U.S. corporate income tax rate. This election also entitles the individual to claim deemed paid foreign tax credits⁵ that would otherwise be unavailable.⁶

However, a special rule replicates the double tax impact of a U.S. individual receiving a distribution from a U.S. C corporation that pays tax on Subpart F income. More specifically, when a CFC eventually distributes earnings and profits previously taxed in the United States (*e.g.*, Subpart F income), the U.S. Shareholder must still include the distribution to the extent the distribution exceeds the U.S. corporate taxes she previously paid.

Despite all the current talk of employing a Code Sec. 962 election, little has been written about the process of making the election. The individual (and only individual) U.S. Shareholder must make an election by filing a statement making

the election with her return.⁷ The statement must include the following information:

1. The name, address, and taxable year of each CFC to which the individual is making an election and all other entities in the direct or indirect chain of ownership;
2. The amounts from each corporation that are included in the individual's gross income under Subpart F;
3. The individual's pro rata share of the earnings and profits of each CFC that the individual includes under Subpart F and, accordingly, the foreign income taxes paid; and
4. The amount of distributions received by the individual from each CFC from excludable earnings and profits (*i.e.*, the amount of U.S. corporate taxes paid) and from all other earnings and profits, which are includable.

An individual U.S. Shareholder must also provide other information as the IRS may require, but the IRS has never required any additional information since promulgating the election regulations in 1965.

Now, international tax professionals are considering the use of the Code Sec. 962 election to reduce the U.S. taxation of Global Intangible Low-Taxed Income ("GILTI").

Although this column describes how to make the Code Sec. 962 election, the author questions the technical use of making the Code Sec. 962 election to reduce the GILTI tax burden of the GILTI regime on individual U.S. Shareholders.

As part of the Tax Reform Act of 2017, Congress instituted the GILTI regime.⁸ The GILTI regime requires an

inclusion of a CFC's income in excess of a 10% return on assets. More specifically, GILTI is the CFC's income (excluding Subpart F income) less 10% of the adjusted basis of the CFC's depreciable assets. U.S. C corporations receive a 50% deduction from GILTI and a limited deemed paid foreign tax credit, effectively eliminating the U.S. corporate tax for a U.S. C corporation that owns a CFC paying foreign tax at a rate greater than 13.125%.

In contrast, because individual U.S. Shareholders do not receive either the 50% deduction or the limited deemed paid foreign tax credit, individual U.S. Shareholders will pay tax at a 37% rate on their GILTI inclusion. This significant tax difference between a C corporation and an individual has resulted in many international tax professionals pondering the use of the Code Sec. 962 election. Nevertheless, the effectiveness of the Code Sec. 962 election is uncertain. First, it is uncertain that a Code Sec. 962 election will enable an individual U.S. Shareholder to obtain the 50% GILTI deduction and current rumors emanating from the IRS regulation writers in Washington indicate that it will not. Second, it is uncertain whether the subsequent post-corporate tax distribution will receive qualified dividend treatment that is taxed at capital gain rates instead of at ordinary income rates.⁹

Instead of a Code Sec. 962 election, the proper planning would be for the U.S. Shareholder to contribute her CFC to a C corporation. Doing so would ensure the 50% GILTI deduction to the C corporation and a qualified dividend to U.S. Shareholder.

It is somewhat amusing to see international professionals trying to deal with the Act's GILTI regime by making an election under Code Sec. 962, which they have ignored since the 1960s. Despite the relatively straightforward manner to make the Code Sec. 962 election, international tax professionals should more carefully analyze other possibilities, such as having an individual U.S. Shareholder contribute their CFC to a U.S. C corporation.

ENDNOTES

¹ Code Sec. 965.

² Code Sec. 951A.

³ A controlled foreign corporation is a foreign corporation in which 10% U.S. Shareholders collectively owned more than 50%.

⁴ Code Sec. 960.

⁵ Code Sec. 962(a)(2).

⁶ Code Sec. 902.

⁷ Reg. §1.962-2(b). Note that the election does not need to be made on a "timely" filed return.

⁸ Code Sec. 951A.

⁹ *B.M. Smith*, 151 TC, No. 5, Dec. 61,269 (2018).

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