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# Feeling GILTI Enough to Make a Section 962 Election?

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After the passage of Public Law No. 115-97, formerly known as the Tax Cuts and Jobs Act (the "Tax Reform Act"),[1] U.S. individual shareholders of controlled foreign corporations ("CFCs") were faced with a difficult decision. As a general rule, when it comes to CFCs, the Tax Reform Act treats U.S. corporate taxpayers more favorably than U.S. individual shareholders, sometimes drastically so. Individual U.S. shareholders thus had to consider, beginning in tax year 2018, whether to contribute their CFC interests to a U.S. C corporation (or a U.S. LLC that is treated as a corporation for U.S. federal income tax purposes), or instead to continue to hold their CFC interests directly. In the case of continuing direct ownership of CFC shares, many U.S. individual shareholders planned to utilize elections under Section 962, which cause such individual shareholders to be taxed like corporations for certain limited purposes of U.S. outbound taxation.

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These Section 962 elections would allow such shareholders to obtain at least some of the benefits that would have resulted from dropping their CFC interests into an actual domestic corporation. But due to a combination of remaining uncertainty about some of the most significant implications of Section 962 elections in the context of the Tax Reform Act, and distinct differences in the taxation of C corporations versus individuals for general taxation purposes both in the U.S. and beyond, these two options presented a host of new, thorny issues for taxpayers to work through in attempting to decide which option was preferable in a given case.

As relevant guidance has begun to surface on some of the open issues, the potential inequity between the tax treatment of actual C corporations and individuals using Section 962 elections has only continued to grow, making the decision an even more complicated one. Affected individual taxpayers are thus still facing an uphill battle in navigating these options. In most cases, either choice will present some advantages and some disadvantages, and taxpayers and their advisors must therefore work through each of these differences carefully to weigh the relative merits of each and determine whether making a Section 962 actually will be helpful from a global tax perspective.

## Section 962 Elections

Section 962 allows an individual (or trust or estate) U.S. shareholder of a CFC to elect to be subject to corporate income tax rates (under Sections 11 and 55) on amounts that are included in his or her gross income under Section 951(a), or now, after the Tax Reform Act, under Section 951A (i.e., GILTI).

Section 962 was enacted in 1962, effective beginning in tax year 1963, along with the rest of Subpart F. At the time, the top individual tax rate was 91% and the top corporate tax rate was 52% in the U.S. With this new concept of taxing the U.S. individual shareholder on "phantom income" of a CFC which the shareholder did not actually receive, Congress gave taxpayers a means of reducing that current tax burden to the lower corporate tax rate. Additionally, taxpayers were permitted to claim deemed-paid tax credits under Section 960 for taxes paid by the CFC overseas.

According to the legislative history under Section 962, "[t]he purpose of [Section 962] is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. [Section 962] gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad." In this sense, the purpose of Section 962 may be analogized to that of Section 1248(b). Whereas Section 962 applies when an individual U.S. shareholder recognizes Subpart F or GILTI income, Section 1248, which is intended to serve as a backstop to the Subpart F (and now, GILTI) rules, applies when a U.S. shareholder sells stock of a CFC. Both provisions are designed to provide some degree of equity in the treatment of U.S. individual shareholders investing directly in CFCs as compared to U.S. individuals investing instead in U.S. C corporations that in turn make the same CFC investments.

The Section 962 election achieves this desired equity in part by allowing the U.S. shareholder to obtain an indirect foreign tax credit under Section 902 for a pro rata portion of any foreign taxes paid by the CFC. Specifically, Section 962 provides that, under regulations prescribed by the secretary, in the case of a U.S. shareholder who is an individual and who elects to have the provisions of that section apply for the taxable year: 1) the tax imposed under this chapter on amounts which are included in his gross income under Section 951(a) shall (in lieu of the tax determined under Sections 1 and 55) be an amount equal to the tax which would be imposed under Sections 11 and 55 if such amounts were received by a domestic corporation, and 2) for purposes of applying the provisions of Section 960 (relating to foreign tax credits on Subpart F and GILTI inclusions) such amounts shall be treated as if they were received by a domestic corporation.

The U.S. federal income tax consequences of a U.S. individual making a Section 962 election are thus as follows.

- First, the individual is taxed on amounts included in his gross income under Sections 951(a) or 951A at corporate tax rates under Section 11.
- Second, the individual is entitled to a deemed-paid foreign tax credit under Section 960 with respect to the Subpart F or GILTI inclusions, as if the individual were a domestic corporation.
- Third, when the CFC makes an actual distribution of earnings that have already been included in gross income by the shareholder under Section 951(a) or 951A, Section 962(d) requires that the earnings be included in the gross income of the shareholder again to the extent they exceed the amount of U.S. income tax paid on the inclusions at the time of the Section 962 election.

A Section 962 election typically is made with the taxpayer's timely filed tax return for the year to which the election relates (though case law exists permitting an election to be made retroactively in some circumstances). The election is made on an annual basis and may only be revoked with IRS consent. If made, the election applies to all Section 951(a) and 951A inclusions of the U.S. shareholder from all CFCs for that tax year.

## Section 962 and GILTI for U.S. Individual Shareholders

The potential attractiveness of Section 962 elections increased drastically as of January 1, 2018. This is because U.S. corporate tax rates fell to 21%, and the effective tax rate that U.S. C corporations pay on their GILTI income was set at only 10.5% (after accounting for the 50% Section 250 deduction such corporations are permitted to take). Individuals, on the other hand, must pay 37% U.S. tax on their GILTI income inclusions, and are not permitted to take a 50% deduction under Section 250. The question thus arises as to whether Section 962 allows an individual U.S. shareholder to claim the 50% deduction under Section 250, in which case a Section 962 election is of much more value to many more taxpayers. Unfortunately, the answer to this question simply is not yet clear.

From a policy standpoint, the consequences arguably should be the same for an individual shareholder electing under Section 962 as they are for a U.S. C corporation shareholder. As such, the 10.5% rate should be allowed to these electing individuals. Taxing such individuals at the same effective tax rate that corporations pay is the only way to "give[] such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad," which is the intention Congress clearly expressed in enacting Section 962. Without extending the Section 250 deduction to such individuals, this legislative intent cannot be fulfilled, at least under current law.

In support of this argument, the New York State Bar Report issued on May 4, 2018, dealing with the GILTI provisions, noted that the Congressional Conference Report to the GILTI legislation stated an intention for the Section 250 deduction to "be treated as exempting the deducted income from tax" and thus was meant to provide a reduced effective rate on such income. In other words, Section 250 is not a typical deduction provision, but truly was intended to lower the effective rate imposed on relevant income to 10.5%. The rate of 21% should thus never apply to GILTI inclusions (assuming Section 250 remains effective). Rather, GILTI either is taxable at a 37% rate (where realized by a U.S. shareholder taxpayer that is taxed as an individual) or a 10.5% rate (where realized by a U.S. shareholder taxpayer that is taxed as a C corporation).

On the other hand, it can be argued that the language of the relevant statutes is clear and does not support the promulgation of regulations or other non-statutory guidance allowing the deduction to be claimed by individuals electing Section 962. Section 962 (and the regulations under that Section) refers only to taxing the Section 951(a) or 951A inclusion under Section 11 (or 55) at corporate rates, and treating the amounts as received by a corporation for purposes of Section 960 ("the tax imposed under this chapter on amounts which are included in his gross income under section 951(a) shall (in lieu of the tax determined under sections 1 and 55) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation…") The rate under Section 11 currently is 21%, and this is therefore the rate that individuals are directed under Section 962 to pay when the election is made. To lower the effective rate to 10.5%, U.S. C corporations must use Section 250, which is explicitly made available only to "domestic corporations" and is not made available to individuals making 962 elections. The legislative history to Section 250 also does not mention such individual taxpayers. Regulations are expected under Section 250 to resolve this issue, but the timing of such guidance remains uncertain at this time.

If the Section 250 deduction is not made available to an individual who makes a Section 962 election, subpart F and Section 956 inclusions essentially will be taxed more favorably than GILTI inclusions. The reason for this disparate treatment, is that an individual who makes a Section 962 election, could completely eliminate the U.S. corporate income tax on the subpart F or Section 956 inclusion as a result of the foreign tax credit under Section 960, so long as the foreign corporate income tax rate is at least 21%, whereas a GILTI inclusion could only be eliminated completely if the foreign corporate income tax rate is at least 26.25%. This is because a 100% foreign tax credit is available for subpart F or Section 956 inclusions whereas GILTI inclusions are only entitled to an 80% foreign tax credit. It is hard to imagine this was intended by Congress.

## Section 962(d) Guidance- *Smith v. Commissioner*

As noted above, when the CFC makes an actual distribution of earnings which were previously subject to a Section 962 election, the distribution must again be included in income under Section 962(d) to the extent it exceeds the tax that was paid in the U.S. at the time of the Section 962 election. Where the relevant CFC is located in a non-treaty country, it was historically unclear (after enactment of Section 1(h)(11)) whether the dividend realized under Section 962(d) could qualify for Section 1(h)(11) reduced tax rates. Stated differently, the question was whether the distribution was treated as coming from the CFC, or instead from a deemed U.S. C corporation created by the 962 election. This question was answered by the Tax Court in *Smith v. Commissioner*, 151 T.C. No. 3 (September 18, 2018).

In *Smith*, the Taxpayer owned a Hong Kong CFC. For the 2004 and 2005 tax years, the Taxpayer made a Section 962 election as to certain Section 956 inclusions of the CFC. In 2007, the CFC sold its assets. Then, in 2008, the CFC paid a dividend to its shareholder from the earnings that were previously subject to the 962 election. The Taxpayer argued that the dividends received in 2008, under Section 962(d), should be taxable at Section 1(h)(11) rates (15% at that time). The IRS asserted deficiencies, arguing that the dividend was paid by a Hong Kong CFC, and thus was not a qualified dividend, but rather was taxable at ordinary income tax rates (35%). The parties cross-moved for summary judgment on this issue. The Tax Court agreed with the IRS, finding that if Congress wished to allow individuals electing Section 962 to qualify automatically for Section 1(h)(11) rates, it could have said that when enacting Section 1(h)(11), but it did not, and this "silence is controlling."

## Distinctions Between U.S. C Corporations and Section 962-Electing Individuals

Given the uncertainty currently surrounding Section 962 elections, the question arises as to whether every U.S. shareholder is better off simply dropping his or her CFC interests into a domestic U.S. C corporation. For many reasons, however, this may or may not be the case. Inserting a C corporation into such a structure can have many other implications, both foreign and U.S., which must be considered.

For example, a contribution to a U.S. C corporation may give rise to foreign tax and other issues (particularly for U.S. citizen taxpayers living overseas, who often are taxable on a worldwide basis by another country as well as by the United States), including corporate transfer and income tax considerations. A dual U.S.-French citizen living in France who has been conducting an active French business through a local French company for many years prior to the Tax Reform Act may have treated his or her French entity as a corporation for U.S. tax purposes, because the active business income would not have been Subpart F income for U.S. purposes and thus would not have been subject to immediate U.S. taxation. If the same taxpayer now wishes to drop her French CFC interests into a U.S. corporation in order to minimize the adverse impact of the GILTI rules, this transfer could trigger a significant tax in France. For this reason, the taxpayer in question might consider whether a Section 962 election is a better option.

Additionally, placing CFC interests inside a C corporation in the U.S. may create a second layer of tax as to gains on a later sale of the CFC shares that are in excess of the earnings and profits of the CFC. This is because, while the domestic C corporation is entitled to a dividends received deduction under Section 245A for any amounts that are recharacterized as a dividend under Section 1248, that treatment will apply only to the extent of the U.S. corporation's pro rata share of the CFC's earnings and profits. Any excess gain is capital gain to the corporation, taxable at the regular 21% rate (plus potential state and local tax). A liquidating distribution to the individual shareholder will then trigger an additional U.S. tax, and the combination of these taxes may be significantly more costly than a single 23.8% capital gains tax in the event the U.S. individual shareholder had simply held and later disposed of the CFC shares directly (assuming the CFC is resident in a treaty country from the U.S. perspective such that any gain recharacterized at the individual level under Section 1248 would qualify for Section 1(h)(11) rates). A related point is that actual domestic corporations typically will be subject to applicable state and local taxes in the jurisdictions in which they are organized and/or operate. In contrast, an individual making a Section 962 election generally will not be treated as a corporation for state and local tax purposes and thus should not be subject to this additional (i.e., corporate) layer of state and local tax.

Treaty withholding tax rates also may be impacted. For example, reduced 0% and 5% dividend withholding tax rates typically are available only to U.S. C corporation shareholders holding a requisite percentage of shares for an applicable holding period, while treaty rates for individual shareholders receiving such dividends usually are higher, generally 15%. A Section 962 election is not respected for treaty purposes, and thus an individual electing under Section 962 is not entitled to the lower treaty withholding tax rates that may apply to a C corporation.

U.S. C corporations also may provide an important benefit where the relevant CFC is resident in a non-treaty country (meaning a country with which the U.S. does not have a comprehensive income tax treaty), as the U.S. corporation in such cases has the effect of converting what would be non-qualified dividends (taxable at 37%-40.8%) into qualified dividends (taxable at 23.8%). After the holding of the Tax Court in *Smith*, discussed above, any distributions of untaxed earnings and profits from a non-treaty country CFC to an individual who elected under Section 962 clearly are taxable as ordinary income.[2] On the other hand, if the same individual held the shares through a U.S. C corporation rather than making a Section 962 election, the C corporation would be exempt from U.S. tax on its receipt of the dividend, either pursuant to Section 959 or Section 245A, and any later distributions from the U.S. C corporation would be taxable at qualified dividend rates. This issue obviously is of great significance when dealing with clients having operations in Latin America and other areas where U.S. treaties are not common.

Another, more recently clarified difference arises in the context of Section 965 where CFC interests are held through a U.S. S corporation whose shareholder elected deferral under Section 965(i). In many such cases, the individual U.S. shareholder may subsequently have caused the S corporation to contribute its CFC interests to a U.S. C corporation, for GILTI reasons, believing that such a contribution would be tax-free under Section 351 and not a Section 965 "triggering event." According to the final Section 965 regulations, however, such a Section 351 transaction is in fact a triggering event for purposes of Section 965 and thus would eliminate the possibility of indefinite deferral that Section 965(i) provided (though the shareholder may still elect an 8 year deferral under Section 965(h)). In these situations, a Section 962 election could have allowed the same taxpayer to avoid a triggering event, while still obtaining some of the GILTI-related benefits available to U.S. C corporations.

The treatment of U.S. individual C corporation and individual shareholders also differs markedly for Section 956 purposes under current law. Proposed regulations were recently issued that would render Section 956 inapplicable to U.S. corporate shareholders of CFCs. The relevant CFCs can thus make loans to related U.S. C corporation shareholders, or have their shares pledged as collateral, without any consequences under Section 956. An individual U.S. shareholder in the exact same circumstances, on the other hand, would instead be taxable at ordinary income tax rates on any Section 956 inclusions, as under prior law. The Section 956 results to the individual do not change if a Section 962 election is made (in other words, the individual making the Section 962 election is *not* treated as a corporation for purposes of Section 956).

Another significant distinction arises under Section 964(e)(4), which now has the effect of recharacterizing gain from the sale of lower-tier CFC interests by an upper-tier CFC as Subpart F income to the U.S. shareholders, but adding that such Subpart F income inclusions are eligible for the dividends received deduction under Section 245A. Since Section 245A is available only to U.S. C corporations, this means that gain realized by a U.S. C corporation shareholder from such a disposition is exempt from U.S. tax, while the same gain realized by an individual U.S. shareholder is taxable as ordinary income (at 37% -40.8%). This result likewise is unaffected by a Section 962 election.

## Potential Use of Retroactive 962 Elections

Finally, another point worth noting is that Section 962 may be of particular use where retroactive relief is needed. While it generally is not possible to retroactively create a U.S. C corporation where no entity actually existed at the relevant time, it often is possible to make a Section 962 election with retroactive effect. Since the election is made with the taxpayer's return for the year, there is always some grace period between the actual realization of relevant amounts and the deadline for making an election that would apply to such amounts. But in some cases, it may be possible for taxpayers to make Section 962 elections years after the fact, as long as the relevant inclusions under Subpart F or the GILTI rules were not previously known to the taxpayer.

Such late election relief is made possible by the holding of the Tax Court in *Dougherty v. Commissioner*, in which the taxpayer was assessed additional amounts of tax under section 951(a)(1)(B) for an earlier year due to inclusions under Section 956 resulting from intercompany indebtedness. As soon as the IRS informed the taxpayer in *Dougherty* that it planned to assess such amounts, the taxpayer filed an election under Section 962. The IRS argued that the election was invalid because it was not made within the time prescribed by the regulations under Section 962 (i.e., with the timely-filed tax return), while the taxpayer contended that the election was made as soon as it appeared relevant, and should thus be considered timely.

In response to the IRS's argument, the Tax Court found it significant that "[Dougherty did] not involve the kinds of difficulties inherent in other situations, where the granting of a right of late election permits the taxpayer in effect to play both ends against the middle as the result of hindsight." In support of its holding that the taxpayer acted properly in making the election as soon as it appeared to him that any amount might be includible under section 951(a)(1)(B), the Tax Court cited several federal appellate court cases for the proposition that in the context of an election (in the cases cited, an election to take a credit, rather than a deduction, for foreign taxes was at issue), it is "sufficient for the taxpayer to indicate its election when it appears that a tax is due and when, therefore, an election first has significance."

Thus, *Dougherty* supports the proposition that a Section 962 election is timely if made when the election first becomes significant to the taxpayer as a result of an assessment of tax on amounts includible under Section 951(a), and presumably also under Section 951A. The IRS fully acquiesced in *Dougherty* with respect to the Section 962 issue in GCM 36325. In cases involving unknowing taxpayers, such as dual citizens living abroad and not keeping up with U.S. tax reform, who may unknowingly realize GILTI inclusions, and then discover the GILTI-related benefits of contributing their CFC shares to a U.S. C corporation, years after the fact, this opportunity to retroactively seek relief by making a Section 962 election can be extremely helpful, and may be the only viable relief measure available.

[1] All references to "Section" refer to Sections of the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[2] An open issue not yet ruled on in *Smith* is whether the non-treaty country CFC can effectively be redomiciled to a treaty country before distributing its untaxed earnings and profits, and through this redomiciliation cause a later distribution of previously earned earnings and profits to be characterized as qualified dividends for U.S. purposes.

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