CODE §962 ELECTION OFFERS BENEFITS UNDER U.S. TAX REFORM

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AN INTRODUCTION TO CODE §962

Under Code §962, an individual U.S. Shareholder may elect to be treated as a domestic C-corporation for the purpose of computing income tax on its share of Subpart F Income. This special election was enacted in 1962, and Treasury Regulations followed in 1965 and 1976. As a result of certain international provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") and the lowering of the corporate income tax rate to 21%, it has recently gained more attention. Specifically, the Code §962 election has garnered importance with respect to the transition tax under Code §965 and the new tax on global intangible low-taxed income ("G.I.L.T.I.") under Code §951A.

The controlled foreign corporation ("C.F.C.") rules impose an anti-deferral regime that requires a U.S. Shareholder to recognize certain income, known as Subpart F Income, in a current tax year. This income inclusion is applicable regardless of whether the C.F.C. made an actual distribution to the U.S. Shareholder during the tax year. Subpart F Income generally includes passive-type investment income. However, other types of income may also be caught. A U.S. Shareholder is a U.S. person who directly, indirectly, or constructively owns 10% or more of a foreign corporation's vote or, beginning January 1, 2018, value. A C.F.C. is a foreign corporation in which more than 50% of the vote or value is owned by one or more U.S. Shareholders.

Code §962 generally allows an individual U.S. Shareholder (including a trust or estate) to elect to be treated as a domestic C-corporation for the purpose of computing the individual's income tax on its share of Subpart F Income. As a result

- the amount will equal the tax imposed under Code §11 (relating to corporations), rather than under Code §1 (relating to individuals), and
- the individual may obtain an indirect foreign tax credit for the foreign taxes paid or accrued by the C.F.C. with respect to the Subpart F Income under Code §960.

The election is beneficial when an individual U.S. Shareholder's graduated income tax rate is higher than the corporate income tax rate. It also allows the taxpayer to obtain a deemed-paid deduction, which otherwise would not be available to an individual.

LOWER TRANSITION TAX RATE

In order to create a level playing field for all earnings accumulated abroad in C.F.C.'s and certain other non-U.S. corporations, the T.C.J.A. imposes a transition tax on post-1986 deferred earnings and profits.

Under Code §965, an individual or corporate U.S. Shareholder must include in taxable income its *pro rata* share of accumulated post-1986 deferred foreign earnings of a deferred foreign income corporation ("D.F.I.C.") (the "Code §965(a) inclusion"). This amount is included in a U.S. Shareholder's income as Subpart F Income. A D.F.I.C. is a C.F.C. or any foreign corporation with respect to which one or more domestic corporations is a U.S. Shareholder[1] with positive earnings and profit that have not been subject to U.S. tax. The calculation of the Code §965(a) inclusion relies upon to the greater of a D.F.I.C.'s post-1986 deferred foreign earnings as of November 2, 2017, or December 31, 2017. Taxpayers may use the earnings as of October 31, 2017, instead of November 2, 2017.

The Code §965(a) inclusion is eligible for a dividends received deduction under Code §965(c) (the "Code §965(c) deduction"). The calculation of the Code §965(c) deduction is based on the highest rate of tax applicable to corporations under Code §11 in the taxable year of the inclusion, even if the U.S. Shareholder is an individual. As a result of the Code §965(c) deduction, transition tax on the Code §965(a) inclusion generally applies at two rates: (i) 15.5% for earnings treated as cash or cash equivalents ("cash position") and (ii) 8% for the balance of the earnings. However, because the calculation is based on the corporate rate, the Code §965(c) deduction would result in a higher tax rate for individuals in the highest tax bracket (for whom the current tax rate at 37%). To mitigate this result, the Code §962 election is expected to be made by many individuals.

"An individual U.S. Shareholder that makes an election under Code §962 is eligible for an indirect foreign tax credit . . . which will lower the overall effective tax rate."

It should be noted that the determination of the "cash position" is made based on the balance sheet by reference to cash measurement dates. For calendar year taxpayers, the cash position is the higher of (i) the amount on December 31, 2017, or (ii) the average on December 31, 2016, and December 31, 2015.

In recently issued guidance, the I.R.S. stated that an individual U.S. Shareholder, or an individual investor in a U.S. Shareholder that is a pass-thru entity, can make an election under Code §962 to be subject to the corporate tax rates for the year of the inclusion.[2] In that case, the Code §965(c) deduction will apply to the tax imposed under the corporate income tax rates, rather than the individual income tax rates. As a result, the transition tax rates of 15.5% on the cash position and 8% rate in all other cases will apply.

In the case of a U.S. Shareholder that is a pass-thru entity, the I.R.S. guidance clarifies that the Code §965(a) inclusion and the Code §965(c) deduction are determined at the level of the entity, and the owners of the entity will be subject to tax on their allocable share of the inclusion regardless of whether they are U.S. Shareholders with respect to the foreign corporation. However, the guidance states that regulations will provide that a Code §962 election will be available for individual owners (including trusts and estates) with respect to their share of the income inclusion only if they themselves are U.S. Shareholders with respect to the foreign corporation – meaning only individuals who own directly or indirectly 10% or more of the vote or value in the foreign corporation may make a Code §962 election.

The I.R.S. guidance also provides that the Code §965(c) deduction allowed in determining the taxable income and the tax due as a result of the Code §962 election cannot be used to reduce the individual's tax under Code §1 (*i.e.*, the individual's other taxable income).

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[1] Code §965(e)(1).

[2] Notice 2018-26, §5.

Additionally, as with a corporate U.S. Shareholder, an individual U.S. Shareholder that makes an election under Code §962 is eligible for an indirect foreign tax credit attributable to foreign taxes paid or accrued on the C.F.C.'s Code §965(a) inclusion (although the credit is subject to a haircut),[3] which will lower the overall effective tax rate applicable for the Code §965(a) inclusion.

INDIRECT FOREIGN TAX CREDIT & DEDUCTION FOR G.I.L.T.I.

G.I.L.T.I. Basics

Very broadly stated, the G.I.L.T.I. provision under Code §951A effectively adds a new category of income that is subject to the Subpart F Income rules for which deferral will not be available. This provision applies to U.S. Shareholders of a C.F.C. and is intended to counter the incentive to shift profits, not otherwise included as Subpart F Income, outside the U.S. due to the newly implemented participation exemption system.[4]

The G.I.L.T.I. calculation starts with the C.F.C.'s gross income. The regime provides a "safe zone" based principally on a hypothetical yield generated by the C.F.C. on its adjusted basis in its tangible property (*i.e.*, plant, property, and equipment), determined on a pre-tax basis. Once the safe zone is computed, all items of the C.F.C.'s gross income that are (i) not otherwise taxed as income effectively connected with a U.S. trade or business or under Subpart F and (ii) not otherwise specifically excepted by Code §951A are considered to be attributable to G.I.L.T.I. As a result, and despite its name (global intangible low-taxed income), G.I.L.T.I. includes more than the C.F.C.'s earnings from intangible property.

When a U.S. Shareholder is a corporation, several rules apply. First, a deemed-paid foreign tax credit is allowed under Code §960 for foreign income taxes allocable to G.I.L.T.I. at the level of the C.F.C. Second, the portion of G.I.L.T.I. subject to Subpart F treatment (the "G.I.L.T.I. inclusion") includes a "gross-up" under Code §78 for the foreign income taxes claimed as a credit. Third, the corporate U.S. Shareholder is entitled to a 50% deduction (reduced to 37.5% in tax years beginning in 2026) on its G.I.L.T.I. inclusion under Code §250 (the "Code §250 deduction"), which results in an effective tax rate of 10.5% up to, and including, tax year 2025.

The deemed-paid foreign tax credit applicable to G.I.L.T.I. is subject to limitations generally not found in the U.S. foreign tax credit rules. For these purposes, G.I.L.T.I. is in a separate credit limitation basket, and excess credit is not allowed to be carried forward or carried back. Under the provision, a corporate U.S. Shareholder is permitted a credit of up to 80% of its *pro rata* share of the income taxes paid or accrued on the C.F.C.'s G.I.L.T.I.

The Effects of the Code §962 Election on G.I.L.T.I.

An individual U.S. Shareholder may make a Code §962 election with respect to a G.I.L.T.I. inclusion. The election will permit the individual U.S. Shareholder to be

[3] Code §965(g).

[4] Under the T.C.J.A., Code §245A provides a corporate U.S. Shareholder with a 100% deduction for the foreign-source portion of dividends received from a specified 10%-owned foreign corporation.

taxed on the G.I.L.T.I. inclusion at the 21% corporate income tax rate. This may be a considerable benefit for the individual U.S. Shareholder, since the current highest individual income tax rate is 37% and individuals generally are subject to net investment income tax at a rate of 3.8% but corporations are not.[5] Further, if such an election is made, the individual U.S. Shareholder will be permitted to claim a deemed-paid foreign tax credit with respect to foreign taxes paid or accrued by the C.F.C. on earnings attributable to the G.I.L.T.I. inclusion.

"When a U.S. Shareholder receives an actual distribution from a C.F.C. that is or was subject to tax as Subpart F Income, the distribution is treated as P.T.I. and is not taxed again."

While the application is not free from doubt, it is sensible that an individual U.S. Shareholder who makes a Code §962 election would be allowed to take the Code §250 deduction on its G.I.L.T.I. inclusion. Uncertainity around the Code §250 deduction stems from regulations promulgated under Code §962, which provide that in computing the tax due as a result of a Code §962 election no deductions of a U.S. Shareholder will be allowed.[6]

In recent I.R.S. guidance on Code §965, the I.R.S. stated that it intends to issue regulations clarifying that the Code §965(c) deduction applicable to domestic corporations will apply to an individual making a Code §962 election. The I.R.S. states that these anticipated regulations will not apply to other deductions and that the above mentioned limitation under Code §962 will continue to apply. As a result, practitioners remain divided on the availability of the Code §250 deduction to individuals making the election. Some argue that this regulatory limitation seems to refer to deductions otherwise available to the U.S. Shareholder and not to deductions available to the hypothetical domestic corporation, which are geared at getting to an applicable corporate tax rate. Others argue that the guidance specifically applies to the Code §965(c) deduction and hints that it will not be available for other deductions, including corporate deductions. The industry eagerly awaits further I.R.S. guidance on the application of these principles to the G.I.L.T.I. regime.

EFFECT OF CODE §962 ON ACTUAL DISTRIBUTIONS

Generally, under the C.F.C. rules, earnings attributable to amounts included in the gross income of a U.S. Shareholder are not included in gross income again when actually distributed. The amount already taxed is referred to as "previously taxed income" ("P.T.I.").[7] This provision ensures that the same earnings attributable to Subpart F Income are not subject to double taxation at the time of an actual distribution. Thus, when a U.S. Shareholder receives an actual distribution from a C.F.C. that is or was subject to tax as Subpart F Income, the distribution is treated as P.T.I. and is not taxed again.

When an individual U.S. Shareholder makes a Code §962 election with respect to a C.F.C., an actual distribution to the U.S. Shareholder in a subsequent year is treated as a distribution from the C.F.C. to the individual U.S. Shareholder. The hypothetical dividend will be reduced by the tax paid on the G.I.L.T.I. inclusion by the hypothetical U.S. corporation. As result, the G.I.L.T.I. inclusion is subject to tax (i) at the level of the hypothetical U.S. corporation and then again (i) in the hands of the individual U.S. Shareholder when actually distributed (minus the tax already paid by the hypothetical U.S. corporation). Thus, the Code §962 election may result in additional tax.

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[5] Code §1411.

[6] Treas. Reg. 1.962-1(b)(1)(i).

[7] Code §959.

The following examples illustrate how the Code §962 election affects an actual disi-tribution of earnings attributable to a G.I.L.T.I. inclusion. For simplification purposes, during the tax year of the actual distribution, the C.F.C. has no current year G.I.L.T.I. inclusion, and the only other earnings it has are G.I.L.T.I. from the prior taxable year.

The regulations under Code §962 provide ordering rules for cases in which the C.F.C. has income not subject to the election (but possibly subject to the P.T.I. rules) and income from the current and prior taxable years.[8]

Example 1

In tax year 1, the taxpayer ("T"), a U.S. citizen, owns 100% of C.F.C. X, which has no income other than $100 of G.I.L.T.I. T makes a Code §962 election for tax year 1. As a result of the election, the effective tax rate on T's G.I.L.T.I. inclusion is 5%, resulting from the deemed-paid foreign tax credit and the 50% Code §250 deduction. Therefore, T pays $5 of tax on the $100 G.I.L.T.I. inclusion for tax year 1.

In tax year 2, when C.F.C. X has no current year G.I.L.T.I. and no other income, it makes an actual distribution of $100 to T attributable to its tax year 1 earnings. T makes a Code §962 election for tax year 2. T will be subject to tax on $95 (*i.e.*, the $100 actual distribution minus the $5 of income tax paid on the amount subject to the election). If the dividend from the C.F.C. is a qualified dividend, T's tax rate on the actual distribution is 23.8% (income tax of 20% and an additional 3.8% net investment income tax, or N.I.I.T.). T's tax on the $95 is $23 (rounded up). T's total tax on the $100 of tax year 1 G.I.L.T.I. inclusion is $28 ($5 + $23). If the dividend is not a qualified dividend, it is taxed at the rates for ordinary income, plus the N.I.I.T.

Example 2

Assume the same facts as before, except that T did not make a Code §962 election for any tax year. In tax year 1, T must pay tax on its G.I.L.T.I. inclusion at the ordinary individual tax rate. Assume T's ordinary tax rate is 37%. In addition, T is subject to the 3.8% tax on net investment income. As a result, T's total tax on the G.I.L.T.I. inclusion will be $41 (rounded up). In tax year 2, the actual disitribution will be P.T.I. and thus not subject to further taxation.

In the examples, the taxpayer pays less overall tax under the Code §962 election and can control the timing of the taxation by delaying an actual distribution. However, such a result may not occur under other circumstances, such as where the hypothetical corporation's tax rate on the G.I.L.T.I. inclusion is higher and the taxpayer's individual tax rate on ordinary income is lower.

IN SUMMARY

The T.C.J.A. made Code §962 more significant, particularly with respect to the transition tax and G.I.L.T.I. Depending on the facts, an individual U.S. Shareholder may achieve substantial tax savings by accessing corporate tax treatment under Code §962. The application of the election raises certain questions that call for I.R.S. guidance. The guidance will ultimately confirm the extent to which tax savings avail-able to an individual U.S. Shareholder using the Code §962 election.

[8] See, Treas. Reg. §1.962-3.