CODE §962 ELECTION: ONE OR TWO LEVELS OF TAXATION?

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Since 1962, a 10%[1] individual U.S. Shareholder in a controlled foreign corporation ("Individual U.S. Shareholder" and "C.F.C.," respectively) can elect to be treated as a corporation for Code §951(a) purposes.[2] As a result of this election, the individual is taxed at corporate rates on its Subpart F Income. Another main benefit of the election is that it enables the individual to claim indirect foreign tax credits for foreign income taxes paid by the C.F.C. on its Subpart F Income.[3] An actual distribution of Subpart F Income to the individual is then taxed to the extent the distribution exceeds the taxes paid on the Subpart F inclusion under the Code §962 election.[4]

Under Public Law 115-97, two new provisions allow for the Code §962 election in additional scenarios: the global intangible low taxed income ("G.I.L.T.I.") regime and the one-time deemed repatriation tax regime of Code §965. This begs the question, is an actual distribution under these regimes subject to traditional treatment under Code §962, or does the new law provide for a different result?

ACTUAL DISTRIBUTIONS PURSUANT TO CLASSIC CODE §962 ELECTIONS

As indicated earlier, an Individual U.S. Shareholder is taxed at corporate rates on its Subpart F Income if a Code §962 election is made. Further, indirect foreign tax credits may be available under Code §960.[5] If the C.F.C. makes an actual distribution to the Individual U.S. Shareholder, the Individual U.S. Shareholder must include in gross income the excess of the earnings and profits ("E&P") over the amount of income tax paid by the Individual U.S. Shareholder on such E&P pursuant to a Code §962 election.[6] However, an actual distribution from the C.F.C. to the Individual U.S. Shareholder may be taxed at an adverse rate.

In *Smith v. Commr.*,[7] the Tax Court was asked to examine serval issues, including whether an actual distribution of taxable E&P from a C.F.C. located in Hong Kong (prior to which the Individual U.S. Shareholder had made a Code §962 election) could constitute a qualified dividend for purposes of Code §1(h)(11)(B)(i) and, hence, benefit from the lower Qualified Dividend income tax rate.

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1 By vote or value.

2 Code §962(a)(1).

3 Code §962(a)(2).

4 Code §962(d).

5 *Supra* n. 3.

6 *Supra* n. 4.

7 *Smith v. Commr.*, 151 T.C. 5, U.S. Tax Court, 09/18/2018.

Code §1(h)(11)(C)(i) defines the term “Qualified Dividend” as a dividend received during the taxable year from (i) Domestic Corporations and (ii) Qualified Foreign Corporations. For this purpose, a Qualified Foreign Corporation is any foreign corporation if (i) the foreign corporation is incorporated in a possession of the U.S. or (ii) the corporation is eligible for benefits under a comprehensive income tax treaty with the U.S. that the Secretary determines is satisfactory for this purpose and that includes an exchange of information program.

In determining that the taxable amount of distributed E&P did not qualify as a Qualified Dividend, the Tax Court looked at the Hong Kong C.F.C. Since no income tax treaty existed between Hong Kong and the U.S., no qualified dividend treatment could apply to a taxable dividend distribution pursuant to Code §1(h)(11)(C)(i).

The Tax Court also made it clear that a Code §962 election by a taxpayer did not create a “notional” Domestic Corporation for dividend characterization purposes.

Thus, in determining qualified or ordinary dividend treatment, the taxpayer must look at whether dividends received from the C.F.C. would constitute Qualified Dividends.

The Tax Court’s decision appears to be in line with the Senate Finance Committee Report related to the adoption of Subpart F in 1962:

> In addition to the minimum distribution schedule and export trade corporation provision which may exclude from the tax base of U.S. Shareholders undistributed income of controlled foreign corporations, the bill provides two other important relief measures. First, it provides that a U.S. shareholder who is an individual may elect to be taxed upon any undistributed income of a controlled foreign corporation attributed to him as if he were a corporation rather than an individual. If he makes this election this means that he will be subject to a 30-percent tax on the first $25,000 of undistributed income allocated to him and a 52-percent tax on all income allocated above this level. Against this 52-percent or 30-percent tax rate, credits will be allowed for income and other creditable taxes paid by the controlled foreign corporation to foreign countries in the same manner as if the individual were a domestic corporation.
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> The purpose of this provision 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. This provision 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.
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> If an individual has elected with respect to the earnings of a controlled foreign corporation to be treated as if he were a domestic corporation, and then subsequently an actual distribution is made, the bill provides that he then is to be taxed only on the excess of the amount received over the amount of taxes he previously paid with respect to the undistributed income. Therefore, if the individual were to be taxed on $100 of undistributed income at a 52-percent tax rate,

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> and then subsequently the $100 was paid to him as a dividend, he would be taxed at individual income tax rates only on $48, namely, the excess of the amount distributed to him over the taxes he previously paid, assuming the foreign country involved had no income taxes.[8]

ACTUAL DISTRIBUTIONS AFTER CODE §962 ELECTIONS UNDER CODE §965 AND G.I.L.T.I.

Under Code §965

Code §965 provides that, for the last taxable year of a deferred foreign income corporation ("D.F.I.C.") beginning prior to January 1, 2018, the U.S. Shareholder of the D.F.I.C. must include in income its *pro rata* share of the accumulated post-1986 deferred foreign earnings of the D.F.I.C. A part of this inclusion amount is deductible, so as to arrive, for corporate taxpayers, at an effective 15.5% or 8% income tax rate on such amount. The effective corporate tax rate is 15.5% for the part of the inclusion amount that equals the cash held by the corporation on a specific date. The 8% tax rate applies to the excess, if any, of the inclusion amount over the cash held by the corporation on that specific date. However, for individual shareholders, the effective tax rates, after deduction, are higher than 15.5% or 8% since the computation of the effective tax rate is based on corporate income taxes and not individual income taxes.

The Joint Committee on Taxation's General Explanation of Public Law 115-97 states, in relevant part:

> The rate equivalent percentages are intended to ensure that deferred foreign income of U.S. shareholders is generally subject to comparable rates of tax, without regard to the type of U.S. person who is the shareholder or the different rates of income tax to which a taxpayer may be subject. Individuals who are U.S. shareholders, as well as the individual investors in U.S. shareholders that are pass-through entities, may achieve rate parity with corporate shareholders by electing application of corporate rates for the year under inclusion, under section 962. That section allows such individual U.S. shareholders to make the election for a specific taxable year, subject to regulations provided by the Secretary. ***Consistent with the goal of rate parity where possible, and to avoid duplicative tax on the amounts included in income under this provision, the entire amount of such inclusion, without reduction for the partial participation exemption deduction, is considered previously taxed income of the DFIC for purposes of subpart F*** [emphasis added].[9]

At first glance, the last sentence could be read as indicating that no second level of taxation would occur upon distribution, since the entire inclusion amount, not decreased by the allowable reduction, constitutes previously taxed income of the

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[8] S. Rept. No. 87-1881, at 92 (1962), 1962-3 C.B. 703, 798.

[9] Joint Committee on Taxation, *General Explanation of Public Law No. 115–97* (JCS–1–18), December 2018, p. 361.

foreign corporation for Subpart F purposes. This would suggest that regulations to be promulgated under Code §965 would effectively override Code §962(d), which states that:

> The earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under this section applied shall, when such earnings and profits are distributed, ***notwithstanding the provisions of section 959(a)(1)***, be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid under this chapter on the amounts to which such election applied [emphasis added].

Unless Code §965 regulations or other guidance say otherwise – which, arguably, would be in line with the highlighted material above – a subsequent actual distribution of amounts previously taxed under Code §962 could be taxed as a dividend to the extent the distribution exceeds the U.S. income tax previously paid. Qualified dividend treatment would be available only to the extent the foreign distributing corporation is resident in a qualifying treaty partner jurisdiction, as provided by the *Smith* case.

Under Code §951A

A U.S. Shareholder must include its G.I.L.T.I. amount in gross income. Corporate U.S. Shareholders are entitled to a 50% deduction on this G.I.L.T.I. amount included in gross income when determining at the taxpayer's taxable income. The 21% corporate income tax rate is then applied to such taxable amount.[10]

Code §962 provides that if an Individual U.S. Shareholder makes a Code §962 election, he or she should be subject to tax on items included in gross income pursuant to Code §951(a) as if such individual were a corporation. Further, as indicated earlier, the legislative history to Code §962 indicates that an individual making a Code §962 election should be in the same position as a corporation with regard to amounts included in gross income under Code §951(a). Finally, the Joint Explanatory Statement of the Committee of Conference to Public Law 115-97 states that:

> Although GILTI inclusions do not constitute subpart F income, GILTI inclusions are generally treated similarly to subpart F inclusions. Thus, they are generally treated in the same manner as amounts included under section 951(a)(1)(A) for purposes of applying section . . . 962.[11]

Therefore, it may be inferred that an individual who has an income inclusion under G.I.L.T.I. and makes a Code §962 election with regard to such inclusion is entitled to the 50% deduction available to corporations. Barring further guidance eliminating a second level of tax (which one may assume was intended by the new legislation), a subsequent distribution should be treated as a dividend in the hands of the Individual U.S. Shareholder, with qualified dividend rates available only if the C.F.C. is in a treaty partner jurisdiction.

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[10] Code §11.

[11] Committee of Conference, *Joint Explanatory Statement to Public Law 115-97*, December 2017, p. 517.

CONCLUSION

Could distributions to Individual U.S. Shareholders in the context of Code §§965 and 951A be taxed a second time upon an actual distribution? In the context of Code §965, the Joint Committee's explanation suggested that no such second level of tax should be imposed. A similar policy argument can be made for the application of Code §951A. Further clarification, in the form of Treasury regulations or otherwise, would be highly desirable to give an assurance to taxpayers as to the correct tax treatment.

Final regulations under Code §965 were promulgated in January 2019. In response to a specific comment asking for clarification on this point, the Treasury stated a second level of tax would be imposed on a subsequent distribution and that no relief was appropriate. Consequently, taxpayers should anticipate that a second level of tax will be imposed upon a subsequent distribution.

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