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From Obscurity to Spotlight: The Section 962 Election

Section 962 was enacted in the early 1960s as part of the Subpart F regime. It allows individual U.S. shareholders who own, directly or indirectly, 10% or more of the vote or value of a controlled foreign corporation (CFC) to elect to be taxed as a C corporation on their pro rata share of the CFC's Subpart F income or global intangible low-taxed income (GILTI).

Before the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), most tax practitioners were not familiar with Section 962, and very few had ever utilized it in planning. Historically, the Section 962 election has had minimal utility given the parity between the U.S. corporate and individual tax rates (before enactment of the TCJA, the U.S. corporate tax rate was 35% and the highest marginal U.S. individual tax rate was 39.6%). The election was rarely needed in tax planning except in the rare case when the foreign taxes paid by the CFC approximated the U.S. corporate tax rate.

In 2003, with passage of the "Bush tax cuts," which lowered the tax rate on "qualified dividend income" to 15%, some practitioners began to consider the potential benefits of making the election. And more recently, with the enactment of the TCJA, the Section 962 election has been thrust into the spotlight because of the potential benefits it can offer to an individual U.S. shareholder of a CFC with GILTI. For example, with respect to a GILTI inclusion, a corporate U.S. shareholder of a profitable CFC receives the benefit of a reduced corporate tax rate (now 21% as opposed to 35%), a special GILTI deduction (50% of its GILTI amount), and access to indirect foreign tax credits, which often largely, if not entirely, mitigate the impact of a GILTI inclusion. However, an individual U.S. shareholder (including those with indirect ownership through pass-through entities) of that exact same profitable CFC receives none of those benefits. The individual is subject to tax on the GILTI inclusion at a top marginal rate of 37%, receives no GILTI deduction, and is unable to utilize any indirect foreign tax credits.

The Section 962 election must be considered by individual U.S. shareholders of CFCs that earn GILTI.

The Section 962 Election

The Section 962 election is intended to put U.S. individuals on an equal footing with domestic corporations doing business abroad. The election is designed to allow an individual U.S. shareholder who invests abroad to elect the same tax treatment that the individual would have received if the individual had invested abroad through a domestic C corporation. The legislative history indicates that Congress's intent was to eliminate possible distortions that could influence a taxpayer's foreign investment decision and remove the administrative hassle of forcing a U.S. shareholder to create a U.S. C corporation solely to obtain a better tax result.

An individual who makes a Section 962 election is taxed as if a domestic C corporation was interposed between the individual and the foreign corporation, putting the individual U.S. shareholder on a level playing field with a corporate U.S. shareholder. The individual is taxed on any Subpart F income or GILTI at corporate tax rates with the benefit of the GILTI deduction and indirect foreign tax credits. But there is also an incremental cost associated with the election. Section 962 creates a legal fiction that must be carried through to completion. When the foreign earnings are ultimately distributed, the individual is subject to taxation on those earnings again as if the individual has invested through a C corporation. Upon an actual distribution of foreign earnings, the individual is again subject to tax on the amount of the distribution that exceeds the amount of tax previously paid on the original inclusion.

An individual U.S. shareholder must weigh these costs and benefits to determine whether, based on the individual's unique circumstances, a Section 962 election is beneficial. There are many factors to consider, including the type of income at issue (Subpart F or GILTI), the country where the CFC is located, and the tax regime in that country. One critical factor for an individual U.S. shareholder who anticipates receiving an actual distribution of foreign earnings subject to a Section 962 election is whether such distribution is eligible for "qualified dividend" treatment.

Smith v. Commissioner

Until September 2018, it was unclear how an actual distribution of foreign earnings was to be taxed when an individual U.S. shareholder made a Section 962 election. Was the individual U.S. shareholder deemed to be receiving a distribution from a domestic corporation as a result of the fiction created by Section 962? Or was the individual receiving a distribution directly from the CFC itself?

In *Smith v. Commissioner*, 151 T.C. No. 5 (Sept. 18, 2018), the U.S. Tax Court held the latter. The Tax Court determined that when an individual taxpayer who makes a Section 962 election receives an actual distribution from a CFC, the distribution is not deemed to come from a fictitious domestic corporation but from the CFC. As a result, if the CFC is organized in a non-treaty jurisdiction, the distribution is ineligible for preferential qualified dividend treatment.

The Tax Court's ruling seems to contradict the legislative intent behind Section 962. Congress's intent was to ensure that an individual's tax burden for undistributed foreign earnings of a CFC would "be no heavier than they would have been had they invested in an American corporation doing business abroad." The Tax Court, however, chose to take a narrow reading of the individual's tax burden for "undistributed" earnings.

Had the taxpayer in *Smith v. Commissioner* invested through a domestic C corporation, the actual distribution of foreign earnings through the chain of ownership would have likely constituted a qualified dividend to the individual shareholder upon receipt. Instead, the Tax Court deemed the distribution to be a non-qualified dividend from the CFC taxed to the individual shareholder at ordinary income tax rates. This result creates planning opportunities and pitfalls for individuals seeking to make Section 962 elections.

Interestingly, in proposed regulations issued on March 6, 2019, the IRS seemingly contradicted the Tax Court's holding in *Smith v. Commissioner* by confirming that an individual U.S. shareholder who makes a Section 962 election qualifies for a GILTI deduction as if the individual were a domestic C corporation. In deciding to extend the GILTI deduction to individuals making a Section 962 election, the IRS reasoned that it was consistent with congressional intent and economically efficient by preventing the need for costly restructurings.

At this point, it is unlikely that the decision in *Smith v. Commissioner* will be appealed. U.S. Tax Court precedent dictates that when an individual U.S. shareholder makes a Section 962 election, he or she will only qualify for preferential qualified dividend treatment if distributions of foreign earnings come from a qualified foreign corporation (i.e., a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States).

When to Consider a Section 962 Election

Generally, a Section 962 election will make sense for an individual U.S. shareholder who has invested in a profitable CFC in a foreign country that has a relatively high corporate tax rate and an income tax treaty in effect with the United States. By making the election in such a situation, the individual U.S. shareholder will be able maximize the benefits that otherwise would only be afforded to a corporate U.S. shareholder while mitigating the effects of corporate double taxation (the actual distribution will likely be eligible for qualified dividend treatment). If the CFC is not in a treaty country, then investing through a U.S. corporate entity may very well be more tax efficient.

But unfortunately, the analysis is not always so cut and dried. Often, there are many other factors at issue based on a taxpayer's unique circumstances that complicate the analysis. For example, even if a U.S. shareholder will not qualify for preferential treatment on an actual distribution of foreign earnings, a Section 962 election may still be beneficial if the CFC does not anticipate making a distribution. The present value benefits of tax deferral may outweigh any future tax costs. Similarly, the analysis gets tricky for an individual U.S. shareholder of multiple CFCs. The Section 962 election is made annually for all CFCs in which an individual is a U.S. shareholder, including indirectly through pass-through entities. The analysis may have to consider the interplay of the tax regimes and profiles of several different foreign countries.

Ultimately, it is often unclear whether a Section 962 election is beneficial for a given taxpayer. Modeling out the scenarios is necessary to evaluate the interplay of the various tax and non-tax considerations to determine whether a Section 962 election makes sense.

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