

## Cushioning the double-tax blow: The section 962 election

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This article was originally published in September 2018, it has been updated to reflect the release of proposed regulations related to section 250 and section 962.

The passage of the [2017 Tax Cuts and Jobs Act \(TCJA\)](#) was heralded as the beginning of a new age in international taxation. Finally, the injustice of the double tax on dividends received by United States shareholders from foreign corporations was put to rest for good ... at least for those United States shareholders who were also already using a corporate tax structure. For those who were not, some temporary relief may be available in the form of a section 962 election.

### Background

Individuals with investments in profitable foreign corporations, including through pass-through entities such as partnerships and S corporations, recently faced current taxation of accumulated foreign earnings as a result of the section 965 tax, regardless of whether they had received any cash dividends from these investments and with no offsetting foreign tax credit (FTC) available. After this, they will continue to deal with immediate double-taxation of foreign earnings on an annual basis under the new Global Intangible Low-Taxed Income (GILTI) regime: the local jurisdiction taxes the income and then the U.S. takes another cut. For a corporate taxpayer, the combination of a reduced corporate rate, a special deduction, and access to indirect FTCs largely mitigates the impact of GILTI – except in scenarios where the foreign entity was paying an extremely low local tax rate. Individuals and pass-through entities receive no such benefits.

Enter the section 962 election: a relatively obscure provision of the Code designed to ensure an individual taxpayer was not subject to a higher rate of tax on the earnings of a directly-owned foreign corporation than if he or she had owned it through a United States corporation. The election may be made on an annual basis with respect to all controlled foreign corporations in which an individual is a United States shareholder, including those owned through a pass-through entity.<sup>1</sup> Individuals who make a section 962 election are taxed as if there was an imaginary domestic corporation interposed between them and a foreign corporation that creates GILTI or other Subpart F income (income of the foreign corporation which is taxable to the U.S. shareholder in the current year even if no dividend was paid).

### Consequences of the election

Consider an individual who owns, directly or through a pass-through entity, 100 percent of a German services company which pays a 30 percent rate of local income tax. If the German company generates \$1,000 U.S. dollars of income, that income is first subject to \$300 U.S. dollars of German taxes, then potentially the entire \$700

remainder could be currently taxed as GILTI and subject to an additional 37 percent U.S. individual tax rate in the year incurred<sup>2</sup> (note that GILTI inclusions are not eligible for the new section 199A business income deduction<sup>3</sup>). The outcome: a current effective tax rate of over 55 percent, regardless of whether the individual owner draws a dividend or reinvests the business' earnings.

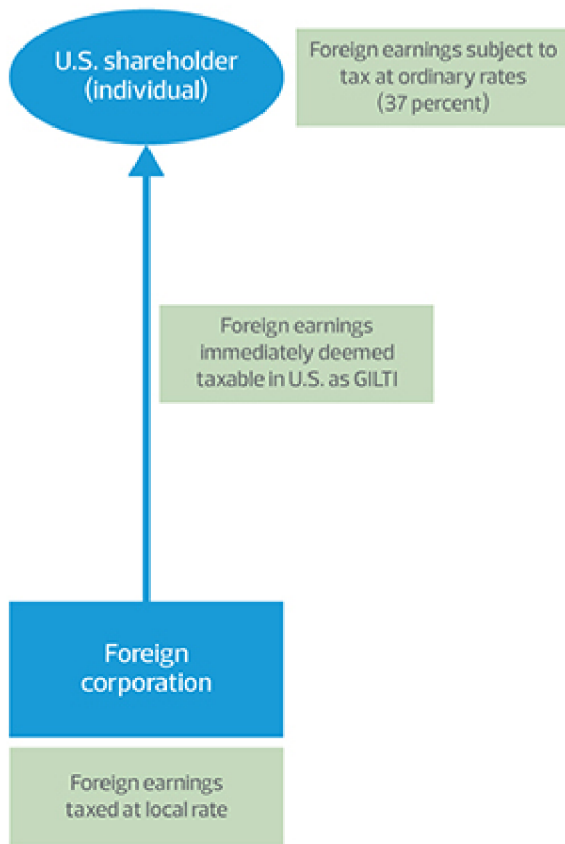
If this individual makes a section 962 election, his or her current tax liability will be reduced. Under section 962, the individual will generally pay tax on his or her pro rata share of GILTI as if he or she were a U.S. corporation. Thus, the reduced corporate rate of 21 percent will apply and the individual may claim an indirect credit with respect to any foreign taxes that the foreign corporation has paid. Treasury also recently proposed regulations which would allow the individual to claim the 50 percent deduction against GILTI which is otherwise only available to corporations.<sup>4</sup> In circumstances like this example where the foreign tax rate significantly exceeds the 21 percent U.S. corporate rate, the election potentially eliminates the GILTI tax entirely. The foreign entity is now free to reinvest its earnings locally without needing to make a distribution so that the individual can pay additional U.S. taxes.

However, there is a reason this election went largely unused until now. Pass-through structures such as S corporations are popular in the United States in large part because they eliminate the domestic double-taxation of corporate income. Just as a section 962 election provides for the benefit of a corporate foreign tax credit, it also creates the detriment of an extra layer of U.S. tax on the dividend. Thus, when a foreign corporation makes a distribution to a United States shareholder who has made a section 962 election, the individual may pay tax at normal ordinary income rates but only on the amount of the distribution that exceeds the amount of tax previously paid as a result of the section 962 election. A [recent tax court decision](#) held that such distributions are generally subject to tax at ordinary rates rather than the reduced qualified dividend rate. However, a distribution from a "qualified foreign corporation" would likely be eligible for the lower rates applicable to qualified dividends.<sup>5</sup>

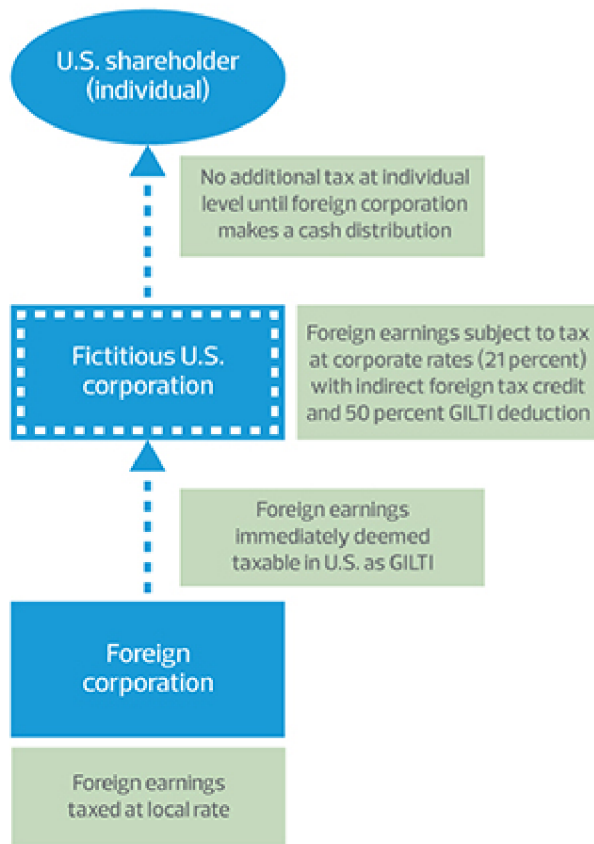
Returning to the facts of the prior example, if the individual makes a section 962 election for the year, the German earnings are now subject to GILTI tax at the deemed-corporate level instead of the individual level. Applying GILTI's rules for corporate indirect foreign tax credits and section 250 deductions, the \$1,000 of pre-tax income is eligible for a 50 percent deduction (\$500 U.S. dollars) and the net income of \$500 U.S. dollars is subject to a 21 percent U.S. corporate rate. A FTC is available of up to 80 percent of the German taxes, or \$240 U.S. dollars. The FTC offsets the full \$105 U.S. dollars of corporate-level tax and, assuming the German earnings are not distributed to the shareholder, there is zero residual U.S. tax in the current year. If in a future year those \$700 U.S. dollars of earnings are distributed, they will be treated as a qualified dividend to the shareholder taxable at 20 percent, for an extra \$140 U.S. dollars of U.S. tax at the shareholder level. This brings the total worldwide tax liability to \$440 U.S. dollars, a much better answer than the \$559 U.S. dollars of worldwide tax in the absence of the election. Because of nuances such as differing foreign tax rates and qualified dividend rates only being available with respect to investments in certain countries, the exact differential in tax with and without the election will vary depending upon each fact pattern considered.

The following diagram compares the treatment of a taxpayer who makes a section 962 election to one who does not:

## No section 962 election



## With section 962 election



### Pros

- Flexible annual election
- Provides benefit of 21 percent corporate rate on GILTI and subpart F income
- Provides benefit of indirect foreign tax credit on GILTI and subpart F income
- Partial benefit of 50 percent GILTI deduction available to an actual C corporation

### Cons

- Additional administrative requirements in making election annually
- Imposes second layer of tax; could increase effective rate after distribution
- Not eligible for FDII deduction available to an actual C corporation
- Distribution not eligible for qualified dividend treatment available to the shareholder of the C Corporation, unless paid by a qualified foreign corporation

### Conclusion

The section 962 election may be a valuable tool in softening or deferring the double-tax blow of being a U.S. shareholder in a foreign business – but careful consideration should be used before making the election. Depending on the specific circumstances, using section 962 could result in an individual paying a greater effective rate of tax on their foreign earnings once they have been repatriated. The election is administratively simpler than forming an actual intermediary corporation, but subtle differences in distribution ordering and other

rules could cause it to provide a different tax outcomes which would be modeled in advance. The right choice will vary depending on each taxpayer's unique circumstances and needs. A taxpayer considering making this election should consult his or her tax professional or advisor to discuss their specific situation.

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<sup>1</sup> Treasury regulation section 1.962-2(a)

<sup>2</sup> IRC section 951A(a)

<sup>3</sup> IRC section 199A(c)(3)(A)(i). Only income which is effectively connected to a United States trade or business is eligible for the deduction

<sup>4</sup> See Proposed Treasury Regulation section 1.962-1(b)(1)

<sup>5</sup> A qualified foreign corporation generally is a foreign corporation that is: (1) not a passive foreign investment company; (2) resident in a country that has an appropriate information exchange article (or a possession), and (3) eligible for benefits under a treaty that has a comprehensive limitation on benefits article and includes an information exchange program.

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