September 3 2020

US individuals investing in foreign companies should consider a Section 962 election to reduce the GILTI tax burden

Kozusko Harris Duncan | Private Client & Offshore Services - USA

SEVERIANO E ORTIZ,
JENNIE CHERRY,
ALEXANDER LEWIS

Introduction

As a result of the US tax reform of 2017, US individuals investing in foreign companies must be cognisant of potential double taxation of foreign earnings on an annual basis under the new Global Intangible Low-Taxed Income (GILTI) regime. The GILTI tax was a compromise to pay for, in part, the reduction in the US corporate tax rate from 35% to 21%. A foreign company's income is taxed in the foreign jurisdiction where earned, and then, under the revised US tax regime, the US investor must pay the GILTI tax on current earnings. The US tax code has a similar regime called Subpart F that existed prior to the 2017 tax reform and continues to apply, under which income of certain controlled foreign corporations is taxable to US shareholders in the year earned even if no dividend is paid. Those Subpart F rules include an election under Section 962 of the US tax code that may mitigate the double tax burden of GILTI.

GILTI tax

Generally, the GILTI regime imposes a tax on earnings that exceed a 10% return on a company's invested foreign assets. Only US shareholders that own more than 10% of a controlled foreign corporation (CFC) are subject to the GILTI tax. To be more specific, GILTI is the excess of a US shareholder's "net tested income" over a deemed tangible income return. The deemed return is calculated by multiplying 10% by a company's qualified business asset investments, commonly referred to as QBAI. US corporations may be entitled to a deduction of up to 50% of their GILTI inclusion. (For planning considerations regarding CFCs in a non-US trust structure owning US equities, please see "Tax planning for US equities owned in a non-US trust structure.")

US corporations are taxed at the new lower corporate tax rate, provided a special GILTI deduction and may claim indirect foreign tax credits (except in scenarios where the foreign corporation was paying an extremely low local tax rate). However, individuals and pass-through entities that own an interest in a foreign corporation directly do not have automatic access to these benefits, which largely mitigate the impact of GILTI. Instead, to gain access to these benefits, US individuals and pass-through entities should consider alternative planning options. One option US individuals should consider is making an election under Section 962 of the US tax code to be subject to tax at corporate rates.

Section 962 election

Prior to tax reform, the Section 962 election was a rarely used provision, because of the additional compliance difficulties and minimal tax savings, if any. The Section 962 election is designed to place individual and corporate taxpayers on a level playing field. Specifically, the Section 962 election ensures that individual taxpayers are not subject to a higher rate of tax on the earnings of a directly owned foreign corporation than if they had owned it through a US corporation. The election is made on an annual basis and can be changed from year to year. The election can also be made retroactive back to the 2018 tax year, the first year of GILTI's applicability. The election applies to all CFCs in which a US individual is a shareholder, including those owned through a pass-through entity. The Section 962 election accomplishes its goal of levelling the playing field by treating taxpayers that make the election as if there was an imaginary domestic corporation interposed between them and a foreign corporation that creates GILTI or other Subpart F income.

IRS regulations affecting election

A brief history of GILTI and its corresponding regulations is relevant for US taxpayers considering a Section 962 election. As noted, GILTI was enacted in 2017 by the Tax Cuts and Jobs Act. In September 2018 the Internal Revenue Service (IRS) released proposed GILTI regulations that provided computational guidance. Those regulations were notable primarily for what was not included – an exclusion from GILTI for income previously taxed at a high rate (a 'high-tax exception'). In June 2019 the IRS released final GILTI regulations that finalised the computational portions of the prior proposed regulations and issued proposed regulations that included a GILTI high-tax exception. Under the high-tax exception, income previously taxed above 18.9% was excluded from a CFC's net tested income. Under the proposed regulations, the high-tax exception was elective by a CFC's controlling US shareholder, binding on all US shareholders of the CFC, and once made or revoked, could not be changed for a 60-month period.

On 20 July 2020 the IRS released final regulations covering the high-tax exception, as well as proposed regulations covering a revised high-tax exception for Subpart F income. The final GILTI high-tax exception regulations confirm that the high-tax election is now made on an annual basis, and it can be made up to 24 months from the due date of the relevant tax year's return. The GILTI high-tax exception continues to apply to income previously taxed above 18.9%. The election is also made by the US controlling shareholder and applies to all of the CFC's shareholders. As a result, minority shareholders will need to take the majority shareholder's plans into consideration when planning their own tax liabilities. The high-tax exception is another planning tool that taxpayers considering a Section 962 election will need to consider.

Benefits of election

The benefits of the Section 962 election are made clear through an example. Consider the case of a US individual that has invested directly, or through a pass-through entity, in a UK services company that is subject to a 30% local income tax. A UK company that earns $100 of income will pay $30 of UK tax. Absent a Section 962 election (or actual US corporation blocker), the US individual could be currently taxed on the remaining $70 at a 37% US individual tax rate in the year incurred. As a result, the effective rate of tax will be over 55%, regardless of whether the US individual receives distributions from the UK company or it reinvests the business' earnings.

The US individual can reduce the effective tax rate in this scenario by making a Section 962 election. Under this election, the US individual will pay their *pro rata* share of GILTI as if they were a US corporation. Accordingly, the individual will be subject to the reduced corporate rate of 21% and they may claim indirect foreign tax credits with respect to any foreign taxes that the foreign corporation has paid. Regulations finalised in 2020 now allow the individual to claim the 50% deduction against GILTI, which is otherwise available only to corporations. In circumstances like this example where the foreign tax rate significantly exceeds the 21% US corporate rate, the election potentially eliminates the GILTI tax entirely. The foreign company is now free to reinvest its earnings locally without needing to make a distribution so that the US individual shareholder can pay additional US taxes.

The Section 962 election has the following positive aspects:

- election is made each year (no need to review);
- taxpayers may amend returns going back to 2018 to retroactively make the election;
- election applies to all CFCs owned by the individual;
- election may be made by an individual shareholder (including a trust or estate) considered to own a domestic pass-through entity (eg, an individual who owns an S corporation or partnership, which in turn owns a CFC);
- benefit from 21% corporate tax rate on both GILTI and Subpart F income, instead of the higher individual marginal rates with a possible 3.8% net investment income tax;
- benefit from Section 960 foreign tax credits, since Section 902 foreign tax credits no longer exist (ie, foreign tax credits may offset Subpart F income and 80% of foreign tax credits may offset GILTI);
- benefit from 50% GILTI deduction;
- benefit from Section 250 foreign-derived intangible income deduction; and
- ability for partial tax deferral on foreign earnings (ie, deferral of second layer of tax that will be owed upon actual distribution to individual).

Potential downside

Despite the clear benefits described above, the Section 962 election was previously unpopular for a reason. Many individuals conduct business in the United States through pass-through structures such as S corporations, because they eliminate the second layer of domestic tax applicable to corporate income. So while the Section 962 election allows individuals access to the reduced rate and a corporate foreign tax credit, the hypothetical corporation interposed between the individual and the foreign corporation creates the detriment of an extra layer of US tax on any dividends received. Upon receipt of a distribution, the US individual that makes a Section 962 election may pay tax at normal ordinary individual income tax 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.

Note, distributions from foreign corporations may qualify for reduced qualified dividend rates, although a 2018 US tax court decision did find that such distributions are generally subject to tax at ordinary rates instead. However, distributions from "qualified foreign corporations" are likely eligible for the reduced qualified dividend rate. (For additional details on qualified dividend income, please see "Overview January 2020.") A qualified foreign corporation generally is a foreign corporation that is:

- not a passive foreign investment company;
- resident in a country that has an appropriate information exchange article (or a US possession); and
- eligible for benefits under a treaty that has a comprehensive limitation on benefits article and includes an information exchange programme.

The Section 962 election has the following negative aspects:

- election must be made each year;
- election applies to all CFCs owned by the individual;
- additional administrative requirements;
- potential exposure to higher effective tax rate even though deferral still possible if CFC had delayed its distribution of profits;
- no benefit from Section 245A 100% participation deduction on future distributions;
- no benefit from Section 959(a) exclusion, meaning amounts distributed by CFC in excess of tax previously imposed under Section 962 are considered income;
- no benefit from qualified dividend rate unless paid by a qualified foreign corporation;
- qualified foreign corporation is generally:
  - not a passive foreign investment company;
  - resident in a country that has an appropriate information exchange article (or a possession); and
  - eligible for benefits under a treaty that has a comprehensive limitation on benefits article and includes an information exchange programme; and
- net investment income tax of 3.8% could apply.

Example

Returning to the facts of the prior example, if the US individual makes a Section 962 election for the year, the UK 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 certain deductions, the $100 of pre-tax income is eligible for a 50% deduction (ie, $50) and the net income of $50 is subject to a 21% US corporate rate. A foreign tax credit of up to 80% of the UK taxes, or $24, is available. The foreign tax credit offsets the full $10.50 of corporate-level tax and, assuming that the UK earnings are not distributed to the shareholder, there is zero residual US tax in the current year. If in a future year the $70 of earnings are distributed, they will be treated as a qualified dividend to the shareholder taxable at 20% for an extra $14 of tax at the shareholder level. As a result of the Section 962 election, the worldwide tax liability is $44. Absent the election, the worldwide tax liability would have been $55.90. Because of nuances, such as varying foreign tax rates, qualification for qualified dividend rates and complicated foreign tax credit rules, the exact differential in tax with and without the election can vary widely depending on each fact pattern considered.

Comment

The Section 962 election has become one of the most common planning tools for tax professionals over the past couple of years. However, it is important to keep in mind that each situation is different. With variables ranging from projected actual future distributions to local country tax rates, it is always important to consider making a Section 962 election among other planning alternatives, not as the only planning alternative. Prudent practitioners will model out this option and compare it with the other options to determine the situation that best aligns with a client's goals. Other options, varying in complexity, may include making an entity classification election to treat the CFCs as passthrough or disregarded entities, inserting a US corporation as a form of blocker or other structuring alternatives. As always, a qualified tax professional should be consulted to ensure that the best course of action is implemented.

For further information on this topic please contact Severiano E Ortiz in the Kozusko Harris Duncan Washington DC office by telephone (+1 202 454 6721) or email (sortiz@kozlaw.com), Jennie Cherry in the Kozusko Harris Duncan New York office by telephone (+1 212 980 0010) or email (jcherry@kozlaw.com) or Alexander Lewis in the Kozusko Harris Duncan Washington DC office by telephone (+1 202 454 6720) or email (alewis@kozlaw.com). Please note that the authors are unable to provide legal advice to non-clients. The Kozusko Harris Duncan website can be accessed at www.kozlaw.com.