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§962 ELECTION TO BE TAXED AT CORPORATE RATES ON §951 INCOME

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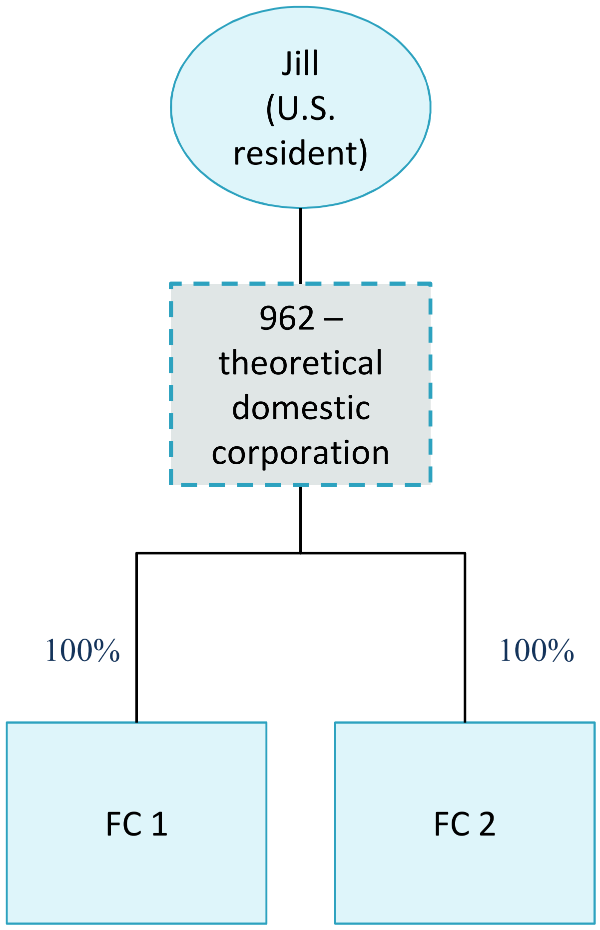
§962 ELECTION- TOPICS COVERED

I. Quantifying the Benefit or Cost of the §962 Election

II. Making the §962 Election

III. Reporting the §962 Tax

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION



- A §962 election is an election by an individual, estate, or trust to be taxed at the corporate rates under §11 on **all** §951(a) income from **all** CFCs in which the taxpayer is a U.S. shareholder.
- At a high level the §962 election imposes tax ‘as if’ a domestic corporation received all §951(a) income only.
- §962 earnings are subject to double tax.
  - When an actual distribution is made from income previously taxed under a §962 election the distribution, less any U.S. taxes actually paid under the election, will be subject to tax again.
  - Distributions come **first** out of excludable 962 E&P and then **second** out of taxable 962 E&P
- §962 has received renewed interest with GILTI, the §250 deduction, and the reduced corporate rate.

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION

- The election is made on a year by year basis.
- For any year made it applies to **all** CFCs and all §951(a) income
  - Includes: Subpart F (FPHCI), §956, §965, and §951A (GILTI)
  - Cannot elect to include certain CFCs and exclude others
- For purposes of computing the §962 tax due - a credit for income taxes paid at the CFC level is allowed under §960.
  - The limitations under §904 apply as they regularly would to a corporation – See Reg 1.962-1(b)(2)
  - Foreign tax credit in GILTI basket cannot offset §962 tax due in other baskets (general, passive)

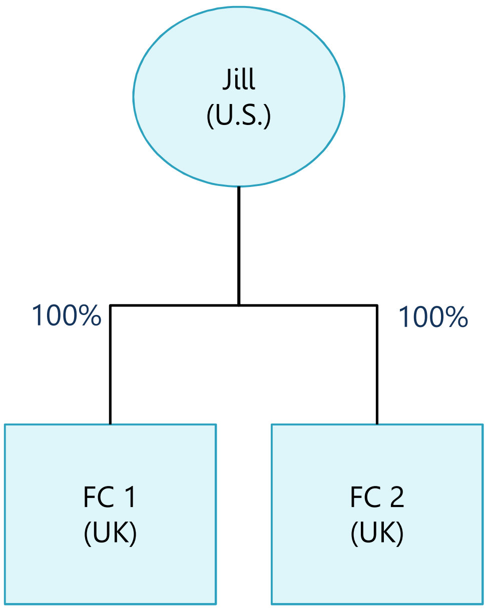
QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION

- A gross up for indirect foreign taxes is required under §78
- Deductions
  - General rule – no deductions are available when computing the tax due under the §962 election.
  - §250 deduction for GILTI is available
  - §245A DRD is not available to offset §956 inclusions

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION

- Taxpayers making the election have an increase in basis under §961 only for the U.S. tax actually paid under the election
- The election does not change the payor of the dividend.
  - For purposes of determining whether the dividend is qualified or the source of the dividend. See *Smith* case.
  - Qualified dividends – paid by qualified foreign corporations
    - Possessions corporations
    - Corporations that are eligible for income tax treaty benefits with the U.S. where there is an exchange of information program (almost all)
    - Corporations that are publicly traded on a U.S. securities market
    - Excludes PFICs

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 1



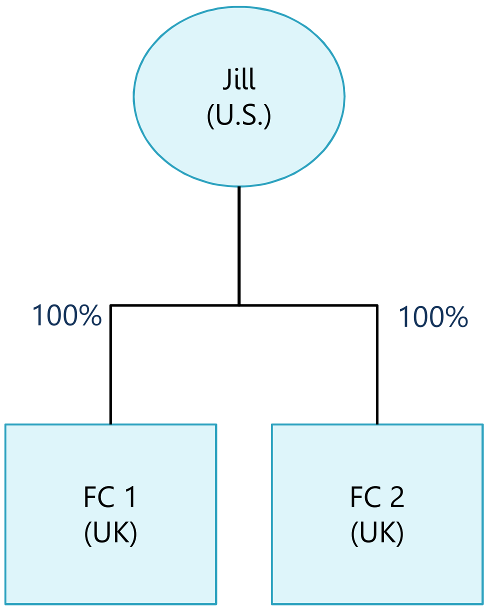
FC 1 and FC 2

- Each have $1,000 of pre tax earnings and no fixed assets.
- Both FC and FC 2 pay 19% CIT in the UK
- All of the earnings are treated as 951A earnings

- Background facts:
  - Jill is a U.S. person subject to tax at the highest marginal tax rates in the U.S.
  - Jill owns 100% of FC 1 and FC 2. FC 1 and FC 2 are UK service companies and do not own any fixed assets.
  - Jill does not own any other CFCs directly or indirectly.
  - FC 1 and FC 2 each have $1,000 of pre tax earnings, no fixed assets, and pay 19% CIT in the UK.
  - Neither FC 1 or FC 2 make any distributions during the year.

Results of FC 1 and FC 2	FC 1	FC 2
Pretax earnings and profits	1000	1000
Foreign income taxes	190	190
Earnings and profits	810	810
951A / 951(a) inclusion	810	810

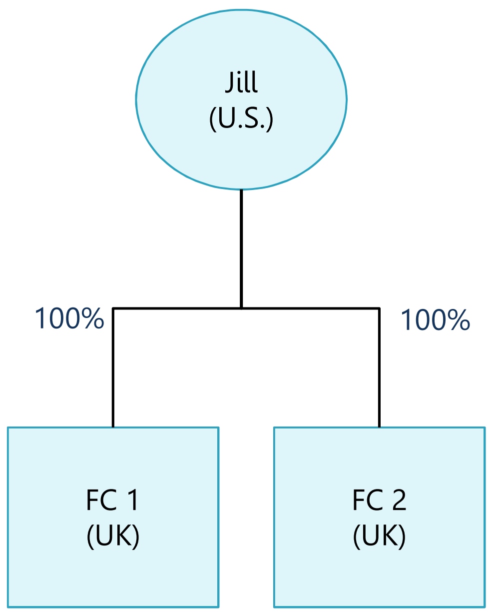
QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 1



FC 1 and FC 2
- Each have $1,000 of pre tax earnings and no fixed assets.
- Both FC and FC 2 pay 19% CIT in the UK
- All of the earnings are treated as 951A earnings

- All of the earnings from FC 1 and FC 2 are GILTI to Jill
- Jill does not make any elections and picks up the deemed income from FC 1 and FC 2 on her U.S. income tax return.
- Jill pays $599 of tax on the §951A income
    - $1,620*37%= **<u>$599</u>**
    - Jill is not able to claim a foreign tax credit on the $380 of corporate income taxes paid by FC 1 and FC 2 in the UK.
- When the $1,620 of earnings are distributed in a future year then the distributions will be treated as PTI and not subject to income tax.
    - The distributions will be subject to NIIT

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 2



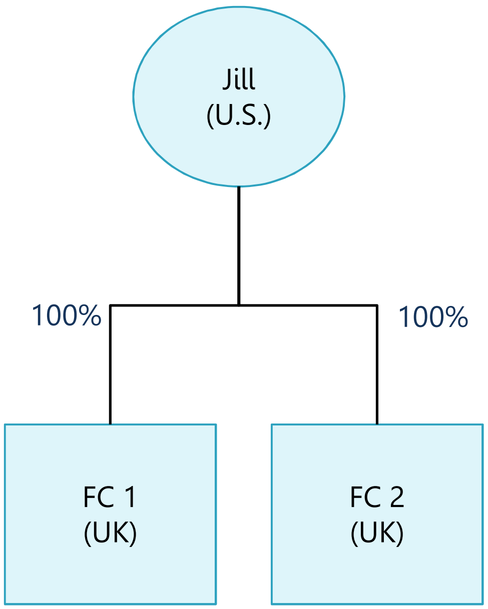
FC 1 and FC 2

- Each have $1,000 of pre tax earnings and no fixed assets.
- Both FC and FC 2 pay 19% CIT in the UK
- All of the earnings are treated as 951A earnings

- Background facts: Same facts as example 1 except that Jill makes a §962 election

§962 tax liability	FC 1	FC 2	Total	
§951A /§ 951(a) inclusion	810	810	1620	
§78 gross up	190	190	380	A
Tentative income	1000	1000	2000	
§250 deduction	-500	-500	-1000	
Net income after deduction	**500**	**500**	**1000**	
CIT 21%			210	B
Foreign tax credit (lesser of 80% of A or B)			210	C
§962 tax liability			**0**	

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 2



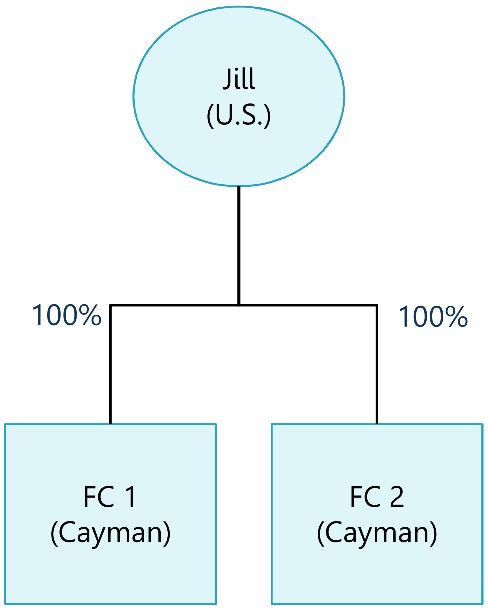
FC 1 and FC 2
- Each have $1,000 of pre tax earnings and no fixed assets.
- Both FC and FC 2 pay 19% CIT in the UK
- All of the earnings are treated as 951A earnings

- When the $1,620 of earnings are distributed in a future year then the distributions will be subject to tax.
  - The UK is a country with a comprehensive income tax treaty with the U.S.. If we assume that FC 1 and FC 2 are qualified foreign corporations the distribution will be eligible for the preferential 20% rate.
  - Tax due will be **$324** ($1620*20%) before taking into account NIIT.
  - Savings of **$275** ($599-$324) plus the benefit of deferral.

TRANSLATION OF FOREIGN CURRENCY INTO USD

- Amounts are first determined under a foreign corporation's functional currency.
- Rules for translating taxes and earnings and profits including deemed inclusion amounts are under §986.
  - Foreign taxes – average exchange rate for the year
  - §951 inclusions – average exchange rate for the year
  - Actual distributions – spot rate
    - Potential for gain or loss where PTI is distributed - §986(c)
      - With §962 election – limited PTI limited to actual taxes paid.
- Tested items (such as tested income, tested loss, and QBAI) - average exchange rate for CFC's inclusion year – see §1.951A-1(d)(1)

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 3



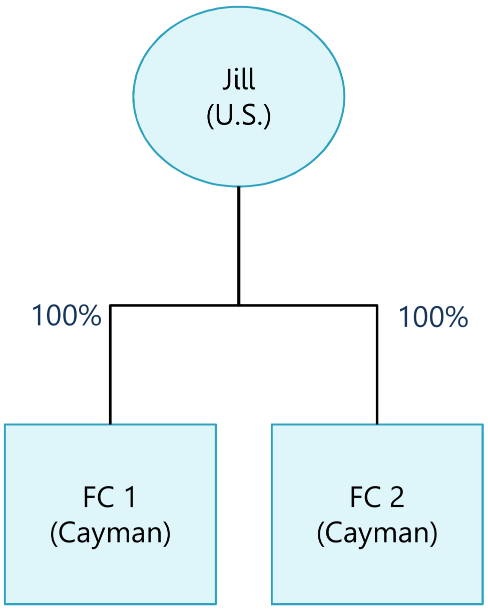
FC 1 and FC 2

- Each have $1,000 of pre tax earnings and no fixed assets.
- FC and FC 2 do not pay CIT
- All of the earnings are treated as 951A earnings

- Background facts: Same facts as example 2 except that FC 1 and FC 2 are Cayman corporations and pay no tax.

§962 tax liability	FC 1	FC 2	Total	
§951A /§ 951(a) inclusion	1000	1000	2000	
§78 gross up	0	0	0	A
Tentative income	1000	1000	2000	
§250 deduction	-500	-500	-1000	
Net income after deduction	**500**	**500**	**1000**	
CIT 21%			210	B
Foreign tax credit (lesser of 80% of A or B)			0	C
§962 tax liability			**210**	

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION – EXAMPLE 3

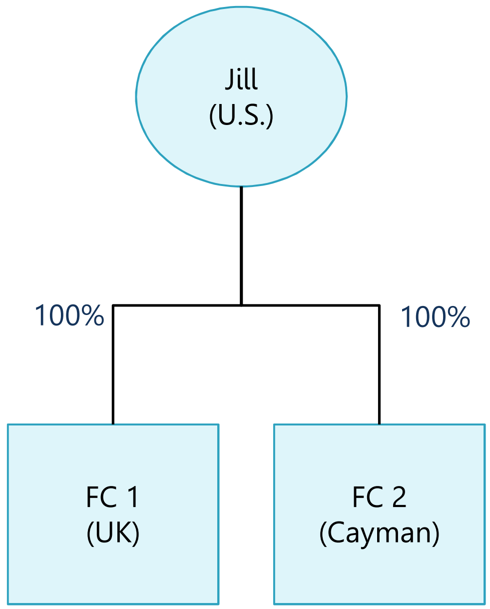


FC 1 and FC 2

- Each have $1,000 of pre tax earnings and no fixed assets.
- FC and FC 2 do not pay CIT
- All of the earnings are treated as 951A earnings

- When the $2,000 of earnings are distributed in a future year then tax due at the time of distribution will be $662 = ($2,000-$210)*37% (before taking into account NIIT)
- Total tax with 962 election is **$872** ($662+$210)
- Liability without 962 is **$740**= $2,000 * 37%.
- By making a 962 election Jill has an increase in tax liability on a fully distributed basis but has the benefit of deferral.

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION– EXAMPLE 4



FC 1 and FC 2

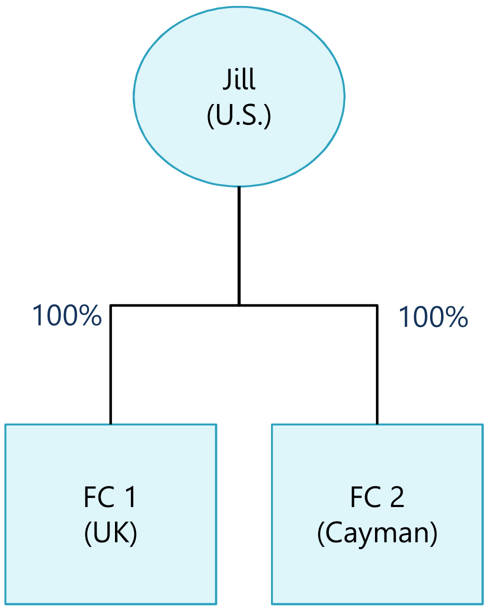
- Each have $1,000 of pre tax earnings and no fixed assets.
- FC 1 is a UK corporation and pays 19% CIT.
- FC 2 does not pay CIT
- All of the earnings of FC 1 are treated as 951A earnings
- The earnings of FC 2 are FPHCI

- Background facts: Same facts as example 2 except FC 2 is a Cayman corporation and the income from FC 2 is Subpart F (FPHCI) income

§962 tax liability	FC 1	FC 2	Total	
§951A /§ 951(a) inclusion	810	1000	1810	
§78 gross up	190	0	190	A
Tentative income	1000	1000	2000	
§250 deduction	-500	0	-500	
Net income after deduction	**500**	**1000**	**1500**	
CIT 21%	105	210	315	B
Foreign tax credit (*)	105	0	105	C
§962 tax liability	**0**	**210**	**210**	

*Foreign tax credit limitations of 904 apply. Foreign taxes attributable to the GILTI basket cannot offset the tax liability on income in other baskets.

QUANTIFYING THE BENEFIT OR COST OF THE §962 ELECTION– EXAMPLE 4



FC 1 and FC 2

- Each have $1,000 of pre tax earnings and no fixed assets.
- FC 1 is a UK corporation and pays 19% CIT.
- FC 2 does not pay CIT
- All of the earnings of FC 1 are treated as 951A earnings
- The earnings of FC 2 are FPHCI

- Background facts: Same facts as example 2 except FC 2 is a Cayman corporation and the income from FC 2 is Subpart F (FPHCI) income. FC 1 is a qualified foreign corporation.

Liability on Distribution	FC 1	FC 2	Total
Tentative Distribution	810	1000	1810
962 income tax paid*		210	210
Amounts distributed	810	790	1600
Tax Rate	20%	37%	
Tax liability on distribution	162	292	**454**

- Total liability **$664** = $210+454 (before considering NIIT)
- If no 962 election was made for example 4 then liability would be $670 = ($810+$1,000)*37%
- By making the 962 election there is a small savings on a fully distributed basis plus the benefit of deferral.

DETERMINING WHEN TO MAKE THE §962 ELECTION

- The §962 election has two potential benefits
  - Permanent reduction in tax liability and/or
  - Deferral
- In order to determine when to make the election taxpayers will need to project the tax liability with and without the election both on a current and fully distributed basis.
  - If there is a reduced tax liability on a fully distributed basis the election should be made.
  - If there is an increased tax liability on a fully distributed basis then taxpayers must weigh the benefit of deferral vs the increased tax cost.

DETERMINING WHEN TO MAKE THE §962 ELECTION

Factors in Favor of Making the Election	Factors Against Making the Election
• §951A income represents large portion §951(a) income • Corporation is a qualified foreign corporation (qualified dividend) • Significant deemed paid foreign tax credits are available	• §951A income represents a small portion of total §951(a) income • Foreign corporate tax paid is low - jurisdiction with low/no tax, NOLs in foreign country, incentive rates • Individual has NOLs or foreign tax credits (withholding tax) that can offset §951(a) liability

DETERMINING WHEN TO MAKE THE §962 ELECTION

Factors in Favor of Making the Election

- Large difference between corporate (21%) rate and individual's effective tax rate (up to 37%)
- Trusts – compressed tax brackets
- Significant time period between income inclusion and eventual distribution
- High importance of deferral to taxpayer (time value of money)

Factors Against Making the Election

- Distributions are made from foreign corporation on a regular basis
- Deferral is not important to the taxpayer

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GILTI HIGH TAX EXCLUSION ELECTION

- Election to exclude income that is subject to a high tax (90% of the corporate) from GILTI.
- Proposed regulations expand the ability to make the election under §954(b)(4) to items of income that are not FBCI (Subpart F)
- Election must be made by the CFC's controlling domestic shareholders.
- Effect – may limit the need to make the §962 election in some cases.
- **Not yet effective** – prospective option only but proposed regulations have been published so taxpayers should monitor developments
- See Prop Regs §1.951A-2(c)(6) for the election and §1.951A-7(b) for the effective date.

DISTRIBUTIONS IN SUBSEQUENT YEARS

- Distributions from excludible §962 E&P
  - Treated as a return of capital – not included as income to the extent that there is basis.
  - Adjustments needed to income for NIIT and state income tax purposes
  - Foreign currency exchange gain or loss on distributions of previously taxed income is calculated as the difference between:
    - The value of the distribution translated at the spot rate on the date of distribution, and
    - The U.S. dollar amount at which the earnings were previously included in the U.S. shareholder's U.S. Federal taxable income
  - Exchange gain or loss is ordinary income reportable as other income on the U.S. shareholder's U.S. Federal tax return

DISTRIBUTIONS IN SUBSEQUENT YEARS

- Withholding tax imposed on distributions of PTI
  - If the income was high taxed (in the inclusion year) – then tax credits go to the same basket as the income in the inclusion year (general/GILTI)
  - If the income is not high taxed then
    - Tax credits go to the passive basket to the extent of the Section 11 corporate rate times the inclusion (after allocation of parent expenses) over taxes already paid or deemed paid the inclusion year.
      - (Section 11 corporate rate) x (PTI) – (taxes paid in year of inclusion)
    - Remainder goes to the basket of the income inclusion (general or GILTI)
  - Guidance under - §1.904-4(c)(6)(iii)
  - Carryover rules of §904(c) apply including disallowance of carryovers for §951A category
- Distributions from taxable §962 E&P – report as a dividend as you regularly would

MAKING THE §962 ELECTION

- The election is made by attaching a statement to a taxpayer's income tax return. The statement must include the following:

I. Name, address, and taxable year of each CFC to which the taxpayer is a U.S. shareholder.

II. Any foreign entity through which the taxpayer is an indirect owner of a CFC under §958(a).

III. The §951(a) income included in the §962 election on a CFC by CFC basis.

IV. Taxpayer's pro-rata share of E&P and taxes paid for each applicable CFC.

V. Distributions actually received by the taxpayer during the year on a CFC by CFC basis with details on the amounts that relate to (1) excludible §962 E&P (2) taxable §962 E&P (3) E&P other than §962.

MAKING THE §962 ELECTION

- The election needs to be made with the taxpayers return.
  - There is no additional guidance on timing (‘original’, ‘timely filed’, etc).
  - Taxpayer was allowed to make the election on amended return after they determined they may have a 951(a) liability – *Dougherty v. Commissioner;* GCM 36325

MAKING THE §962 ELECTION

Election by U.S. Shareholder of a Controlled Foreign Corporation to Be Taxed at Corporate Rates
IRC Section 962(a)

Section 962(a) Election

[redacted] hereby elects pursuant to Section 962(a) of the Internal Revenue Code to be subject to tax at corporate rates on amounts includible in gross income pursuant to Section 951(a) for the year ending [redacted]. THE TAXPAYER elects to utilize a foreign tax credit for taxes paid with regard to the earnings and profits attributable to such amounts. The following information is submitted in compliance with Regulation §1962-2(b):

1) THE TAXPAYER was a U.S. shareholder for the year [redacted] in the following controlled foreign corporations:

Name	EIN	Address	Tax Year End
[redacted]	[redacted]	[redacted]	[redacted]

2) THE TAXPAYER has included the following amounts in income under §951(a):

Name	§951(a) Inclusion
[redacted]	160,847

MAKING THE §962 ELECTION

3) THE TAXPAYER pro rata share of the earnings and profits of each corporation determined under Reg. §1.964-1 foreign income taxes paid with respect to such earnings and profits:

Name	Pro-rata share of Earnings and Profits	Foreign Taxes Paid
[redacted]	306,424.	260,932.

4) THE TAXPAYER received the following distributions from the above corporations:

Name	From Excludable §962 Earnings and Profits	From Taxable §962 Earnings and Profits	From Other Earnings and Profits
[redacted]	NONE	NONE	NONE

5) THE TAXPAYER was not a U.S. shareholder in any other controlled foreign corporations during the year ending [redacted].

REPORTING THE §962 TAX – WHAT TO ATTACH

- §962 Election Statement
- Supporting statement to show calculation
  - No direct guidance on what needs to be included on the statement outside of requirement that it must show the tax was determined. It is generally a good idea to 'show your work' for tax computations so that the return can be followed.
- Form 8992 and Form 8993 where a §962 election is made, there is GILTI, and a §250 deduction is taken (50% deduction on GILTI).

SAMPLE TAXPAYER 123-45-6789

SECTION 962 ELECTION SUPPORTING STATEMENT
==

962 ADJUSTMENT:	GILTI	SUBPART F	TOTAL
GILTI INCLUSION FROM FORM 8992 SCH. A	$ 810,000		$ 810,000
PLUS SUBPART F INCOME		810,000	$ 810,000
PLUS SECTION 960(a)(1)/78 GROSS UP	$ 190,000	190,000	$ 380,000
LESS GILTI DEDUCTION FROM FORM 8993	$ (500,000)		$ (500,000)
TAXABLE INCOME UNDER SECTION 11	$ 500,000	$ 1,000,000	$ 1,500,000
TENTATIVE TOTAL TAX UNDER SECTION 11 (21%)	$ 105,000	$ 210,000	$ 315,000
FOREIGN TAXES AVAILABLE FOR CREDIT:			
80% OF GILTI FOREIGN TAXES PAID	$ (152,000)		$ (152,000)
SUBPART F FOREIGN TAXES PAID		$ (190,000)	$ (190,000)
FOREIGN TAX CREDIT - SEE FORM 1118 ATTACHED	$ 105,000	$ 190,000	$ 295,000
US TAX DUE	$ -	$ 20,000	$ 20,000
TOTAL UNUSED FOREIGN TAXES AVAILABLE FOR CARRYBACK OR CARRYFORWARD	NONE*	$ -	$ -

THE TAXPAYER HAS MADE AN ELECTION TO BE TAXED AS A CORPORATION FOR ANY INCOME UNDER SECTION 951(A). THE ABOVE SECTION 951(A) INCOME IS BACKED OUT OF THE TAXPAYER'S RETURN AND CORPORATE TAX IS COMPUTED ON THE SECTION 951(A) INCOME AND ADDED TO LINE 12A, FORM 1040.

REPORTING THE §962 TAX – WHAT TO ATTACH

- Form 1118 where a foreign tax credit is taken.
  - To take a foreign tax credit a corporation must file this form → "Any corporation that elects the benefits of the foreign tax credit under section 901 must complete and attach Form 1118 to its income tax return."
  - §965 FAQs did explicitly mention the Form 1118 when making the 962 election
- Form 1120 → Some practitioners may prefer to complete a mock form to show how tax is computed but there is no guidance from the IRS suggesting that one is required.

REPORTING THE §962 TAX

- The §962 tax is reported directly on the taxpayer's income tax return and added to any other income taxes due.
  - 2019 1040 12a instructions: "Tax due to making a section 962 election (the election made by a domestic shareholder of a controlled foreign corporation to be taxed at corporate rates). See section 962 for details. Check box 3 and enter the amount and "962" in the space next to that box. <u>Attach a statement showing how you figured the tax</u>."
  - Form 1041 – recommend including on Schedule G Line 8

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