The Form 5471 Series

Episode 10. The Section 962 Election

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The Form 5471 Series: 2003-2004

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1. Introduction

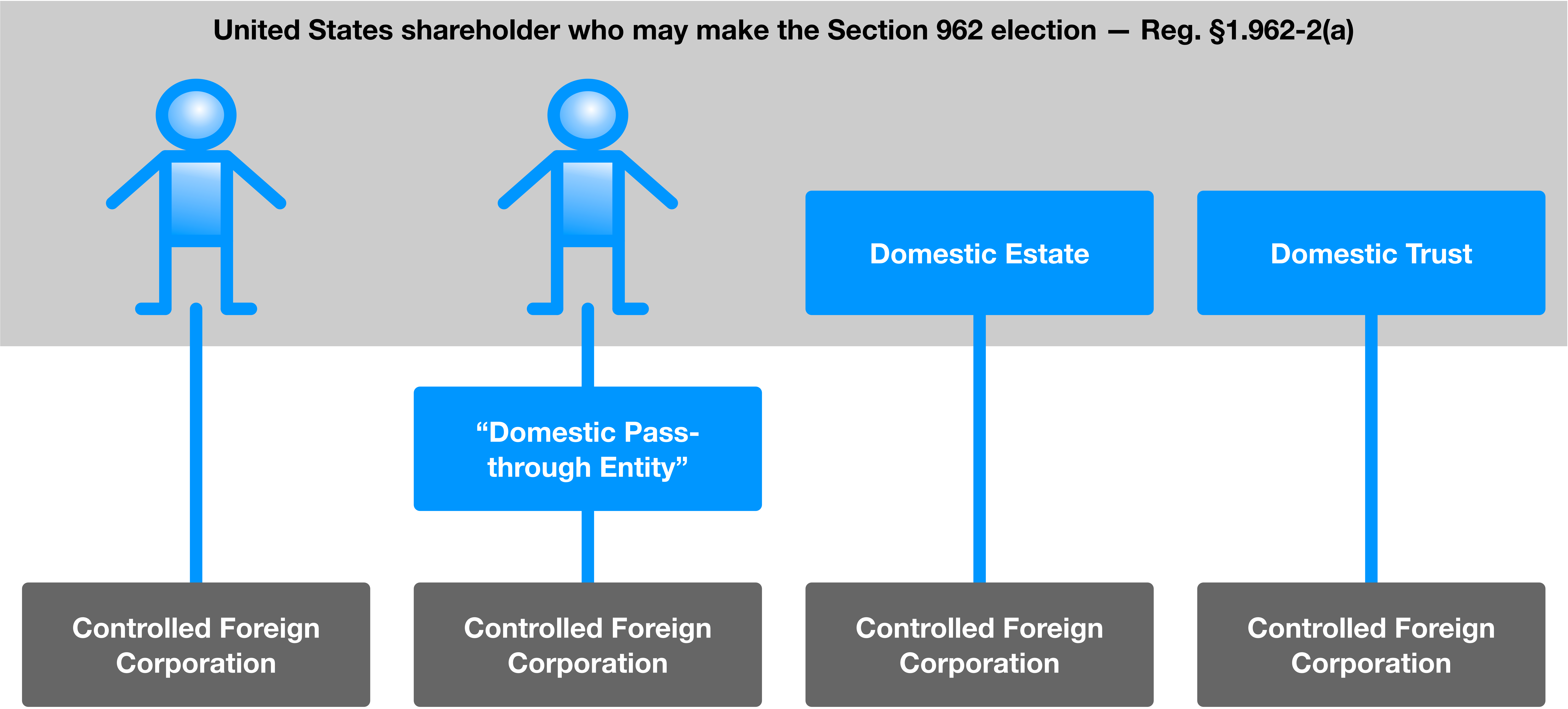
Introduction: Summary

- The Section 962 election is made by individuals.

- It affects subpart F income and global intangible low-taxed income only.

- It makes three things better and one thing worse. Math tells you whether the Section 962 election is good for you.

Who may make the election?



Section 962 alters the U.S. shareholder's tax treatment

	Tax Result Without Section 962 Election	Tax Result With Section 962 Election	Code Sections Applicable to the Section 962 Election
How much of the CFC's income is included in the U.S. shareholder's gross income?	Subpart F: 100%	Subpart F: 100%	IRC §951(a)
	IRC §951A: 100%	IRC §951A: 50%	IRC §§250, 951A(a)
What income tax rate applies to the CFC's income?	Up to 37%	21%	IRC §§11, 962(a)(1)
Can the U.S. shareholder claim a tax credit for foreign corporate income tax paid by the CFC?	No	Yes	IRC §§960, 962(a)(2)
Are the CFC's dividends included in gross income when received by the U.S. shareholder?	Income tax: no	Income tax: yes	IRC §962(d)
	NIIT: yes	NIIT: yes	Reg. §1.1411-10(c)(1)(i)(A)(1)

Procedural features of the Section 962 election

- **Year-by-year**. Make the Section 962 election one year and not the next? That's fine. *IRC §962(a).*

- **All or none**. The Section 962 election applies to all controlled foreign corporations for which the U.S. shareholder has gross income inclusion. *Reg. §1.962-2(c)(1).*

- **Method**. Made by attaching a statement to the individual's income tax return. *Reg. §1.962-2(b).*

CFC solutions to consider instead of the Section 962 election

- **Foreign passthrough entities**. Form one or use check-the box rules.
- **Domestic corporation** operating as a branch in a foreign country.
- **U.S. parent/foreign subsidiary** structure.
- Make yourself **not be a U.S. shareholder** of a controlled foreign corporation.
- Make the foreign corporation **not be a controlled foreign corporation**.
- Use the **high-tax exception**.

2. Election Effect #1. Reduces IRC §951A Income Inclusion by 50%

The IRC §250 deduction is allowed to an individual who makes the IRC §962 election. The deduction offsets 50% of the U.S. shareholder's global intangible low-taxed income inclusion.

Summary: reduce global intangible low-taxed income with a deduction

- Only domestic corporations can use the IRC §250 deduction. *IRC §250(a)(1).*
- But an individual who makes a section 962 election is allowed to use the IRC §250 deduction. *Reg. §1.962-1(b)(1)(i)(B)(3).*
- The IRC §250 deduction does not apply to subpart F income.

IRC §250: an arbitrary and automatic 50% deduction for no reason

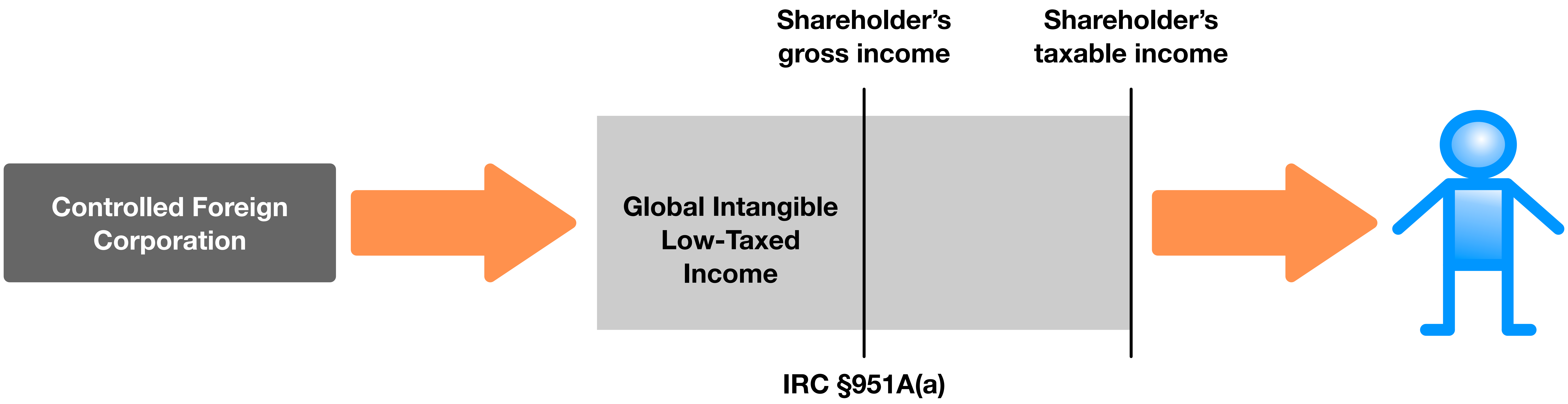
"(1) *In general*. In the case of a **domestic corporation** for any taxable year, there shall be allowed as a deduction an amount equal to the sum of—

(B) 50 percent of—

(i) the global intangible low-taxed income amount (if any) which is included in the gross income of such domestic corporation under section 951A for such taxable year[.]"

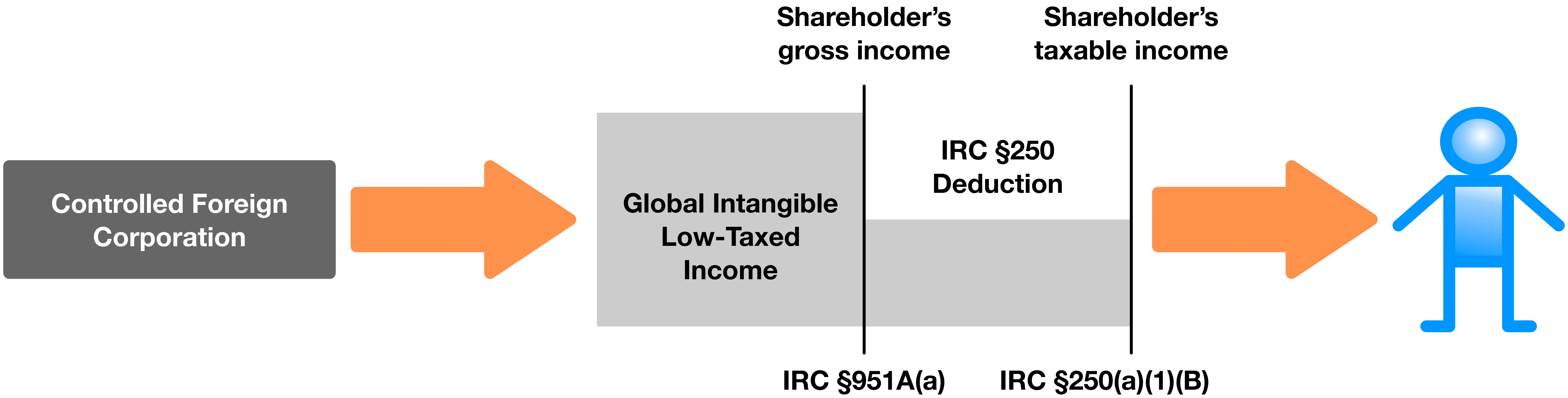
- *IRC §250(a)(1)(B)(i). Emphasis added.*

No election: 100% of global intangible low-taxed income is taxable



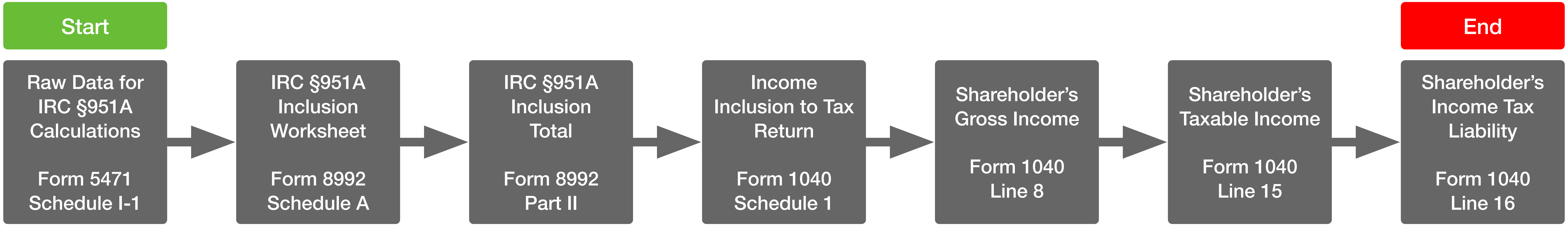
Without the Section 962 election, all of the global intangible low-taxed income included in the shareholder's gross income will become taxable income.

With election: 50% of global intangible low-taxed income is taxable

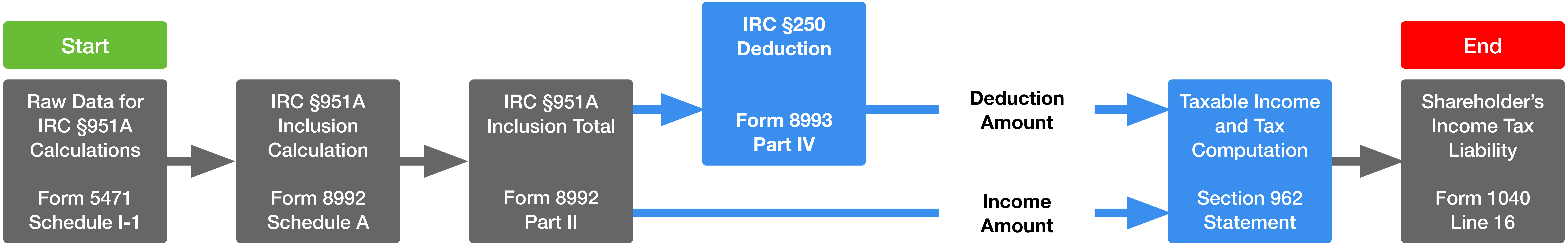


The Section 962 election allows the individual shareholder to reduce the global intangible low-taxed income inclusion created by IRC §951A(a). The election enables use of the IRC §250 deduction, which is an automatic and arbitrary 50% of the inclusion amount. IRC §250(a)(1)(B).

How tax liability is calculated on IRC §951A income



Calculation of U.S. Shareholder's Tax Liability From Global Intangible Low-Taxed Income Inclusion, Without Section 962 Election



Calculation of U.S. Shareholder's Tax Liability From Global Intangible Low-Taxed Income Inclusion, With Section 962 Election

Conclusion

- The section 962 election enables an individual to claim the IRC §250 deduction.

- That deduction reduces the global intangible low-taxed income amount included in the individual's gross income by 50%.

- The IRC §250 deduction does not apply to subpart F income inclusions.

- Therefore, when considering a section 962 election for a taxpayer, consider the type of income generated by the controlled foreign corporation. *If the CFC generates mostly subpart F income, this specific benefit of the section 962 election will not be useful to the taxpayer*.

3. Election Effect #2. CFC Income is Taxed at the Corporate Rate

Subpart F income and IRC §951A income is taxed at corporate income tax rates (IRC §11) rather than individual income tax rates (IRC §1)

Flat 21% income tax rate on CFC inclusions: IRC §962(a)(1)

> "[T]he tax imposed under this chapter on amounts which are included in his gross income under section 951(a) shall (in lieu of the tax determined under sections 1 and 55) be **an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation**[.]"

- Includes global intangible low-taxed income. *Reg. §1.962-1(b)(1)(i)(A)(2).*

- Includes IRC §78 deemed dividend. *Reg. §1.962-1(b)(1)(i)(A)(3).*

4. Mathematical Interlude: Effects #1 and #2

The combined impact of enabling the IRC §250 deduction and using the IRC §11 income tax rate. Math. You can guess what happens.

Combined effect of IRC §250 deduction and lower tax rate

Assume the CFC does not pay foreign country corporate tax paid	No Section 962 Election	Section 962 Election
IRC §951A gross income inclusion	600,000	600,000
IRC §250 deduction	Not allowed[1]	(300,000)
Net IRC §951A income inclusion	600,000	300,000
Less: standard deduction (2024 single taxpayer)[2]	(14,600)	Not applicable[3]
Taxable income	***585,400***	***300,000***
Tax rate (IRC §§1, 11)	Average rate 30%[4]	21%
Income tax liability	**175,265**	**63,000**
Income tax savings		112,265

Footnotes for slide 21 (tax liability comparison)

1. The IRC §250 deduction is limited to domestic corporations and individuals who make the Section 962 election.

2. Standard deduction amount for 2024 for a single taxpayer. Rev. Proc. 2023-34, Section 3.15.

3. Tax liability on global intangible low-taxed income is computed under the principles of IRC §11 because of the Section 962 election. A corporation does not claim a standard deduction in computing its corporate taxable income.

4. When we apply $585,400 to the 2024 tax brackets for single filers and compute the tax, we end up with an average 29.9393% tax rate. I rounded up to 30%. Computation in the spreadsheet on the next slide.

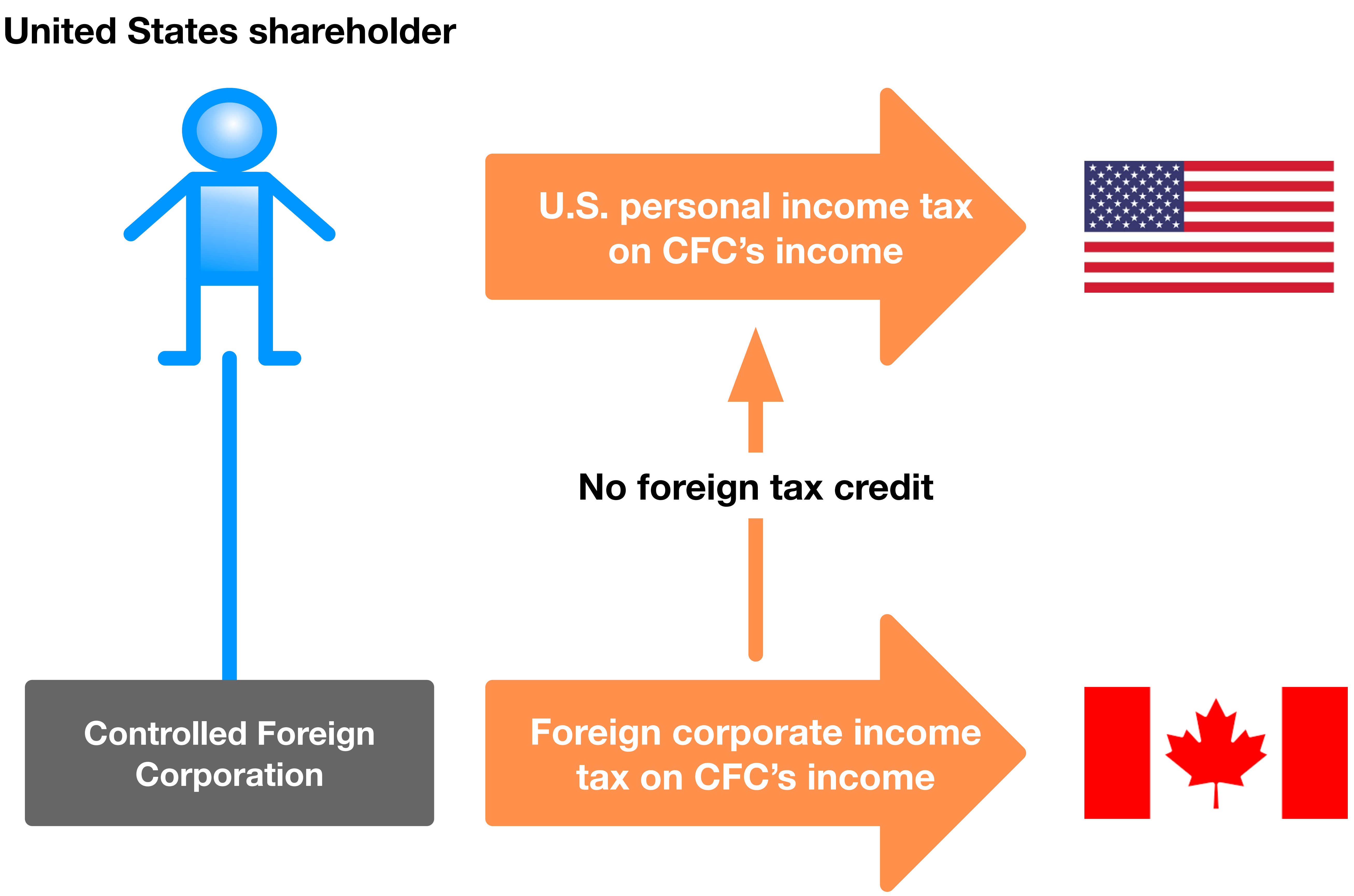
Footnote 4. Calculation of tax rate (2024 brackets, single)

Bracket Start	Bracket End	Amount in Bracket	Bracket Tax Rate	Taxable Income	Taxable Income Used	Taxable Income Carried	Tax
-	11,600	11,600	10%	585,400	11,600	573,800	1,160
11,600	47,150	35,550	12%	573,800	35,550	538,250	4,266
47,150	100,525	53,375	22%	538,250	53,375	484,875	11,743
100,525	191,950	91,425	24%	484,875	91,425	393,450	21,942
191,950	243,725	51,775	32%	393,450	51,775	341,675	16,568
243,725	609,350	365,625	35%	341,675	341,675	-	119,586
609,350	9,999,999	9,390,649	37%	-	-	-	-
Total Tax					585,400		175,265
Average Tax Rate							30%

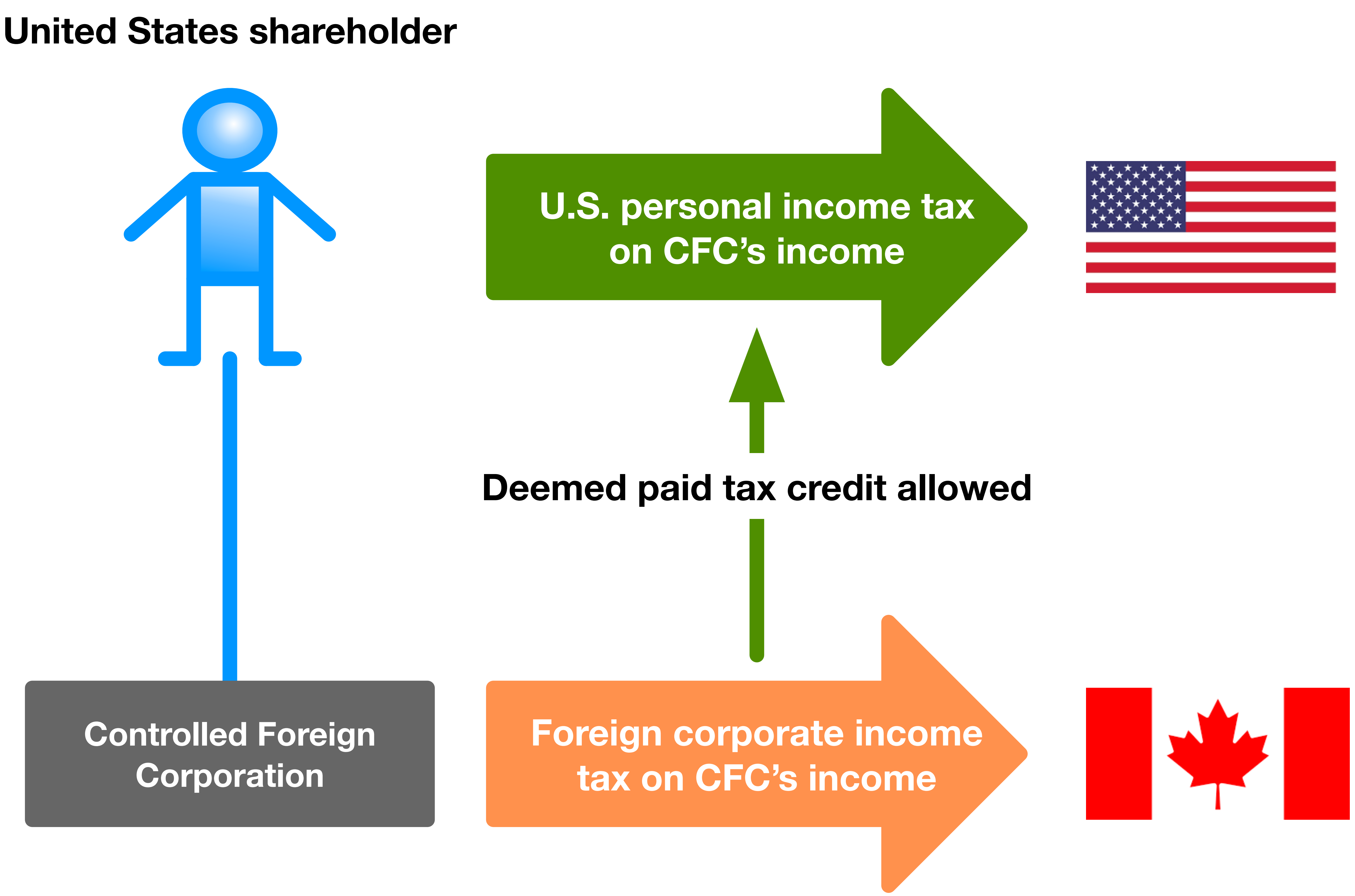
5. Election Effect #3. Activates the Deemed Paid Foreign Tax Credit

The Section 962 election allows individual taxpayers to use the deemed paid foreign tax credit rules (IRC §960) that are ordinarily permitted only for domestic corporations.

Without the Section 962 election, no deemed paid tax credit



The Section 962 election allows the deemed paid tax credit (IRC §960)



IRC §901: the taxes that can be used for foreign tax credit

"If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) **plus, in the case of a corporation, the taxes deemed to have been paid under section 960**. * * * *"

IRC §901(a). (Emphasis added).

Section 962 allows individuals to use the deemed paid foreign tax credit

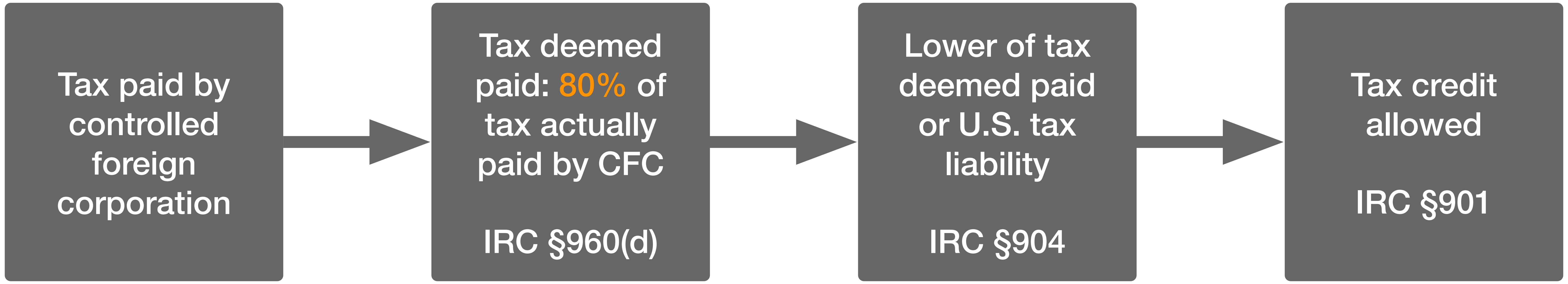
- Individuals who elect Section 962 treatment may claim the deemed paid foreign tax credit of IRC §960, thereby allowing them to claim a foreign tax credit otherwise reserved to corporations by IRC §901(a).

- This is done by pretending that the individual is a domestic corporation:

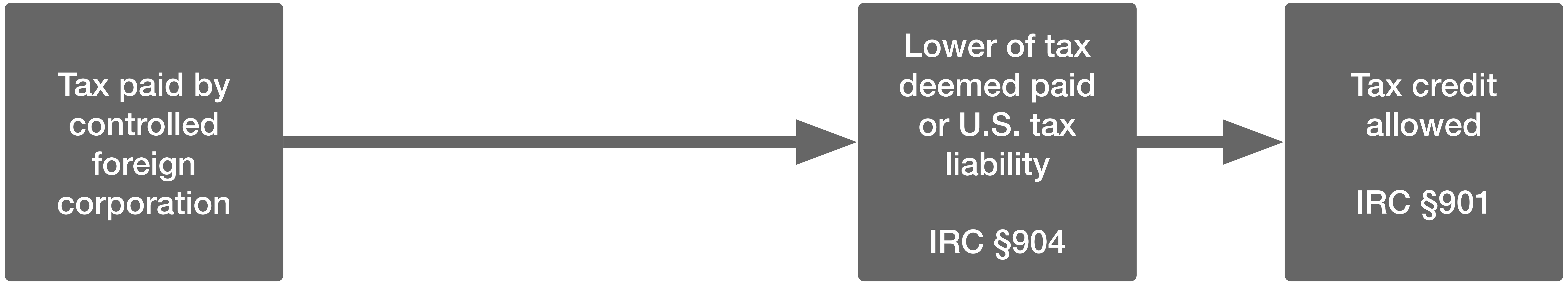
> “[F]or purposes of applying the provisions of section 960 (relating to foreign tax credit) such amounts shall be treated as if they were received by a domestic corporation.”
>
> *IRC §962(a)(2).*

Limitations on the allowable credit amount with Section 962 election

Global Intangible Low-Taxed Income: Two Limitations on Allowable Tax Credit



Subpart F Income: One Limitation on Allowable Tax Credit



Use Form 1118 attached to Form 1040

- "*Controlled foreign corporation (CFC) shareholder*. If you are a shareholder of a CFC and elect under section 962 to be taxed at corporate rates on your section 951(a) amount (which is generally your share of subpart F income and your section 956 amount with respect to investment of earnings in U.S. property), and your global intangible low-taxed income (GILTI) inclusion for the tax year, you may be able to claim a credit for certain foreign taxes paid or accrued by the CFC, but only against your separately computed U.S. tax liability with respect to your section 951(a) amount and GILTI inclusion. To claim the credit, you must file **Forms 1118**, as applicable, and you must also include the **statement** required under Regulations section 1.962-2 to make the section 962 election.

- *Pub. 514, Foreign Tax Credit for Individuals (2023), page 10.*

6. Side-Effect of Election Effect #3: A Deemed Dividend

If you choose to use IRC §960 to claim the deemed paid foreign tax credit (because now you can), you must add back all of the foreign tax paid by the CFC as additional gross income on your tax return, under IRC §78.

Gross-up income if you claim the deemed paid foreign tax credit

> If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under subsections (a), (b), and (d) of section 960 (determined without regard to the phrase “80 percent of” in subsection (d)(1) thereof) for such taxable year shall be treated for purposes of this title (other than sections 245 and 245A) as a **dividend received by such domestic corporation** from the foreign corporation.
>
> *IRC §78.*

- Note: the gross-up is 100% of tax paid by the CFC, even though only 80% of the tax allocable to global intangible low-taxed income is deemed paid.

7. Mathematical Interlude: Effects #1, #2, and #3

A simple example of “with” and “without” the Section 962 election when a CFC pays foreign corporate income tax but doesn’t pay a dividend to its shareholder.

Step 1. Shareholder's gross income inclusion

	No Section 962 Election	Section 962 Election, IRC §960 credit
CFC taxable income	600,000	600,000
Less foreign corporate income tax paid by CFC (20%)	(120,000)	(120,000)
Shareholder IRC §951A income inclusion (current E & P)	480,000	480,000
Shareholder IRC §78 deemed dividend	Not applicable	120,000
Shareholder total gross income inclusion	480,000	600,000

Step 2. Shareholder’s tax liability before foreign tax credit

	No Section 962 Election	Section 962 Election, With IRC §960 credit
Shareholder total gross income inclusion	480,000	600,000
Less: IRC §250 deduction	Not allowed	(300,000)
Less: standard deduction	(14,600)	Not allowed
Shareholder’s taxable income before foreign tax credit	465,400	300,000
Income tax liability before tax credit	133,265	63,000

Step 3. Foreign tax credit allowable

	No Section 962 Election	Section 962 Election, With IRC §960 credit
Foreign corporate income tax paid by CFC (20%)		120,000
Deemed paid on IRC §951A income IRC §960(d) (80%)		96,000
Actual U.S. tax liability on IRC §951A income inclusion		63,000
IRC §904(a) limitation (lesser of U.S. tax or deemed paid)		63,000
IRC §901(a) deemed paid tax credit allowable	Not allowed	63,000

Step 4. Shareholder’s U.S. tax liability on IRC §951A income

	No Section 962 Election	Section 962 Election, With IRC §960 credit
Income tax liability before tax credit	133,265	63,000
IRC §901(a) deemed paid tax credit allowable	Not allowed	(63,000)
Income tax liability after deemed paid tax credit	133,265	0

Step 5. Worldwide Tax on $600,000 of Taxable Income

	No Section 962 Election	Section 962 Election, With IRC §960 credit
Foreign corporate income tax paid by CFC	120,000	120,000
U.S. income tax on IRC §951A income after tax credit	133,265	0
Worldwide tax paid	253,265	120,000
Worldwide tax paid as percentage of taxable income	42%	20%

8. Election Effect #4. Dividends Are No Longer Tax-Free

Section 962 creates dividend income for a CFC's individual shareholder where none previously existed. IRC §962(d).

8.1. Income Tax: The Election Makes Dividends Mostly Taxable

Summary: Section 962 election and dividends

- **Without IRC §962**: IRC §959 says distributions of previously-taxed earnings and profits are not included in gross income of the shareholder. They're not dividends. Therefore, distributions received do not create taxable income for the shareholder.
  - Note: distributions of previously-taxed earnings and profits *are* still "dividends" for the purpose of the net investment income tax.
- **With IRC §962**: distributions of previously-taxed earnings and profits ARE included in gross income of the shareholder, in the amount above the income tax paid on those earnings and profits. Therefore, distributions are dividends and DO create taxable income for the shareholder.

Without the Section 962 election, dividends are excluded from income

For purposes of this chapter, the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) **shall not**, when (1) such amounts are distributed to . . . such shareholder . . . be again included in the gross income of such United States shareholder

IRC §959(a)(1). Emphasis added.

With the Section 962 election, distributions are (mostly) income

"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."

IRC §962(d). Emphasis added.

The formula for calculating the taxable distribution amount

- Formula:
  - Distribution of section 962 earnings and profits (actual distribution)
  - Minus “excludable section 962 earnings and profits” (federal income tax actually paid on IRC §§951(a), 951(a) inclusions)
  - Equals “taxable section 962 earnings and profits” (your dividend income on Form 1040)
- *Regs. §1.962-3(b)(1).*

An example of how it works: 1962-3 C.B. at 798-799

- "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 $100,000 of undistributed income at a 52-percent tax rate, 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." (Emphasis added).

8.2. Net Investment Income Tax Applies to Dividends, No Matter What

Distributions are dividends for net investment income tax

- The definition of “net investment income” for the net investment income tax is different from the definition of “gross income” for income tax.

- The taxable portion **and** the excludable portion are both distributions from earnings and profits, therefore are dividend income and are net investment income. *IRC §1411(c)(1)(A)(i).*

- This makes the entire distribution subject to net investment income tax.

- *Nota bene*: I believe this is the correct result but the NIIT Code and regulations mention the IRC §959 exclusion but not the IRC §962(d) exclusion, so if you think otherwise please tell me. *Reg. §1.1411-10(c)(1)(i).*

9. Mathematical Interlude: Effects #1, #2, #3, and #4

The IRC §250 deduction, a lower income tax rate, the deemed paid foreign tax credit, and the CFC distributes all of its cash to the shareholder. What's the net effect?

Comparison to show the value of the Section 962 election

- Assume $600,000 of CFC net profit.
- The CFC pays 20% foreign corporate income tax = $120,000.
- $480,000 cash remaining is distributed to the shareholder as a dividend.
- Shareholder pays 40% foreign personal income tax on the dividend income.
- The dividend is an ordinary dividend for U.S. income tax purposes.
- Detailed calculations are in the spreadsheet handout.

Compare: no election, election but no deemed paid credit, full treatment

	No IRC §962	IRC §962, No IRC §960	IRC §962 With IRC §960
Foreign corporation corporate income tax paid	120,000	120,000	120,000
Shareholder's income tax liability: IRC §§951A and 78 income	133,265	50,400	63,000
Shareholder's foreign tax credit against IRC §951A income	Not allowed	Not elected	(63,000)
Shareholder's foreign tax paid on dividend income	192,000	192,000	192,000
Shareholder's U.S. income tax on dividend income	Not income	132,126	151,870
Shareholder's foreign tax credit on dividend income	0	(132,126)	(151,870)
Shareholder's net investment income tax	18,240	18,240	18,240
Worldwide tax load on CFC's fully-distributed income	**463,505**	**380,640**	**330,240**

10. Conclusion

Conclusion

- The most important factor: the deemed paid foreign tax credit
- Hunch: in high-ish tax countries, the Section 962 election makes sense:
  - The deemed paid foreign tax credit eliminates U.S. income tax liability on Subpart F and IRC §951A income inclusions, and
  - The direct foreign tax credit eliminates U.S. income tax liability on dividend income.
- But you won’t know until you run the numbers.

Thank you!

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