

Repatriating Subpart F Income: A Fresh Look at Electing to Be Taxed As a Corporation

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Section 962 of the U.S. Internal Revenue Code was enacted in the early 1960s amid much publicity. As part of subpart F, section 962 was inextricably connected to a new mechanism designed to prevent U.S. investors from using foreign corporations to defer the payment of U.S. taxes. Despite the initial buzz surrounding subpart F as a whole, section 962 was quickly forgotten by many as its utility waned.

After several decades of relative obscurity, section 962 may be close to resurgence, thanks to the recent enactment of the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA).¹ Because of some of the provisions in JGTRRA, section 962 could become an indispensable tool for international tax practitioners.

Qualified Dividends and Qualified Entities Under JGTRRA

Congress enacted JGTRRA in May 2003 in an effort to stimulate the economy. Among the changes introduced was an unprecedented reduction in the tax rate on certain dividends received by individuals. By first lowering the tax rate on net capital gain to a maximum of 15 percent, then broadening the definition of net capital gain to include qualified dividend income (QDI), JGTRRA managed to substantially lessen the tax imposed on certain dividends received by individual U.S. investors.² As it stands now, QDI is taxed as net capital gain at a maximum rate of 15 percent, while non-QDI is taxed

as ordinary income at a maximum rate of 35 percent. With that 20 percent spread at stake, tax practitioners should be intimately familiar with the new rules under JGTRRA.

To be considered QDI, a dividend must meet several conditions. One is that it must be distributed by either a domestic corporation or a qualified foreign corporation (QFC).³ Determining whether a dividend is QDI and whether a foreign entity is a QFC can be difficult. One must consult several sources, including the statutory language in JGTRRA, the relevant congressional conference report,⁴ and a series of notices issued by the Internal Revenue Service.⁵ Although many rules may be gleaned from those sources, others may not.

Some Foreign Corporations Are Pariahs

Regarding QFCs, one of the rules that has developed under JGTRRA is the so-called foreign investment company exclusion test. Under that test, three types of foreign entities are not considered QFCs: foreign personal holding companies (FPHCs), foreign investment companies (FICs), and passive foreign investment companies (PFICs).⁶ Noticeably absent from this list are controlled foreign corporations. Accordingly, tax practitioners have raised some issues about the application of the QDI rules to CFCs and subpart F inclusions.

Joint Committee on Taxation, Summary of Conference Agreement on H.R.2, The Jobs and Growth Tax Relief Reconciliation Act of 2003, JCX-54-03 (May 22, 2003).

³Section 1(h)(11)(B)(i).

⁴Conference Report, Jobs and Growth Tax Relief Reconciliation Act of 2003, 108th Cong. 1st Sess. Report 108-126 (May 22, 2003).

⁵Notice 2003-69, 2003-42 IRB 851 (Oct. 20, 2003); Notice 2003-79, 2003-50 IRB 1 (Dec. 15, 2003); Notice 2004-70, 2004-44 IRB 724 (Nov. 1, 2004); Notice 2004-71, 2004-45 IRB 793 (Nov. 8, 2004).

⁶Section 1(h)(11)(C)(iii). Those entities are defined in sections 552, 1246, and 1297, respectively. For tax years beginning after December 31, 2004, the FPHC and FIC rules have been repealed.

¹Public Law 108-27, May 28, 2003.

²Section 1(h)(1)(C). That rate is reduced to 5 percent or zero percent in some situations. See section 1(h)(1)(B). For a brief overview of section 1(h)(11) and all of JGTRRA, see U.S.

(Footnote continued in next column.)

Income Inclusions Under Subpart F

Subpart F, consisting of IRC sections 951 through 964, is the most notorious anti-tax-deferral mechanism. It generally frustrates tax deferral by forcing U.S. shareholders (that is, U.S. persons who own directly, indirectly, or constructively 10 percent or more of the total voting stock) of some foreign corporations to be taxed annually on their ratable portion of some foreign corporate earnings, even though they do not receive actual distributions during the year. In particular, section 951(a) provides that if a foreign corporation is considered a CFC because more than 50 percent of its stock is owned by U.S. shareholders for at least 30 days, each U.S. shareholder who owns stock in the CFC on the last day of the year must include various items in his gross income.⁷ Those items are commonly referred to as subpart F income or subpart F inclusions.

The Treatment of Subpart F Inclusions Under JGTRRA

Comments From the International Tax Community

Tax practitioners argued subpart F inclusions should qualify as QDI because they are constructive or deemed dividends.⁸ The practitioners offered several arguments in support of that position. First, subpart F inclusions are based on earnings and profits, and E&P is the primary consideration in determining whether a corporate distribution constitutes a dividend.⁹ Likewise, section 956 inclusions are based on applicable earnings determined by reference to section 316, which is the provision that defines the term "dividend."¹⁰ Those two facts demonstrate that taxation under subpart F is inextricably linked to a CFC's dividend-paying capacity — that is, its E&P. Second, subpart F inclusions are treated as dividends for other

purposes of the IRC.¹¹ Finally, the IRS requires that subpart F income be reported as a dividend.¹²

Tax practitioners also questioned the treatment under JGTRRA of actual dividends distributed by CFCs. As explained above, the foreign investment company exclusion test identifies three types of entities that are not considered QFCs, namely FPHCs, FICs, and PFICs.¹³ Since CFCs are absent from the list, logic dictates that actual dividends distributed by CFCs should be considered QDI.¹⁴

The IRS's Response

In response to those and other comments, the IRS issued Notice 2004-70.¹⁵ For CFCs, Notice 2004-70 provides that because JGTRRA does not expressly exclude CFCs from the definition of QFC, any actual dividends distributed by a CFC to an individual shareholder from its non-previously-taxed E&P are generally considered QDI.¹⁶

However, Notice 2004-70 clarifies that subpart F inclusions are not considered QDI because neither section 951(a)(1) nor the corresponding Treasury regulations characterize an inclusion as a dividend. Relying on the argument that if Congress had wanted subpart F inclusions to be considered dividends it would have said so in the statute, Notice 2004-70 points out that other anti-tax-deferral mechanisms characterize some distributions as dividends. For example, section 551(b), which applies to FPHCs, provides that shareholders must include particular undistributed income in gross income as a dividend.¹⁷

The Uncertain Effect of JGTRRA on Section 962

Notice 2004-70 clarified some issues concerning subpart F inclusions, but left other areas, such as

⁷Treas. reg. section 1.951-1(a). Those items typically include the CFC's subpart F income as defined in section 952 and the CFC's earnings invested in U.S. property as defined in section 956. Collectively, those items are referred to as subpart F income or subpart F inclusions.

⁸David E. Kahen, "A Year's Experience With the Taxation of Qualified Dividend Income at Capital Gains Rates," 45(7) *Tax Management Memorandum* (April 5, 2004), pp. 113-114; Todd C. Lady, "Qualified Foreign Corporations: Taxing Foreign Corporation Dividends at Net Capital Gain Rates," 33(6) *Tax Management International Journal* (June 11, 2004), pp. 353-354; Hale E. Sheppard and Scott A. Harty, "Tax Treatment of Foreign Dividends Under the JGTRRA: Further Ambiguities and Opportunities," 15(10) *Journal of International Taxation* 20 (2004).

⁹Section 316.

¹⁰Section 956(b)(1).

¹¹See Priv. Ltr. Rul. 9024026 (Mar. 15, 1990) (on whether subpart F inclusions are treated as dividends under section 512(b) and saying that "the mere fact that the timing of income recognition is accelerated under the Subpart F provisions, as under the foreign personal holding company provisions, does not result in treating the Subpart F inclusion any differently than distribution of an actual dividend in the absence of these rules, unless specifically provided elsewhere in the Code").

¹²IRS Instructions for Form 5471, p. 6.

¹³Section 1(h)(11)(C)(iii).

¹⁴Jeffrey J. Tolin, "Dividend Rate Reduction Under U.S. Jobs and Growth Act of 2003," 14(12) *Journal of International Taxation* 22, 29 (Dec. 2003).

¹⁵Notice 2004-70, 2004-44 IRB 724 (Nov. 1, 2004).

¹⁶*Id.* at section 4.01.

¹⁷*Id.* at section 4.02. See also section 1248(a) (which generally provides that when a U.S. person sells or exchanges stock in a CFC that person must include the gain in his gross income as a dividend).

those surrounding section 962, even murkier. Those murky areas are addressed below.

The Purpose of the Section 962 Election

Section 962 allows an individual U.S. shareholder to elect to be taxed at corporate income tax rates on subpart F inclusions. Section 962 was designed to allow individuals who invest abroad to elect the same tax treatment they would have had if they had invested through a domestic corporation. In other words, section 962 was designed to eliminate possible distortions in the taxpayer's foreign investment decision by effectively permitting individual investors to claim indirect foreign tax credits.

JGTRRA managed to substantially lessen the tax imposed on some dividends received by individual U.S. investors.

The legislative history clarifies that the congressional intent behind the enactment of section 962 election was to tax a U.S. individual on his share of a CFC's undistributed earnings as if that individual were a corporation rather than an individual. The legislative history goes on to state: "This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in [a domestic] corporation doing business abroad."¹⁸

That congressional purpose is carried out by first taxing an individual who makes a section 962 election as if he were a domestic corporation on his subpart F income, then taxing that individual as an individual on actual distributions.

Tax Consequences of Making a Section 962 Election

If an individual U.S. shareholder makes a section 962 election, there are three main tax consequences.¹⁹ First, the individual is taxed on amounts included in his gross income under section 951(a) at

corporate tax rates.²⁰ Second, the individual is entitled to a deemed-paid foreign tax credit under section 960 as if he were a domestic corporation.²¹ Third, and most importantly for this article, when the CFC makes an actual distribution of E&P that has already been included in gross income by the shareholder under section 951(a), the E&P is included in gross income again to the extent it exceeds the amount of U.S. income tax paid at the time of the section 962 election.²²

As many international tax practitioners know, section 959 generally allows previously taxed E&P to be excluded from shareholder income when actually distributed by the CFC.²³ Section 962, however, overrides the general rule of section 959 and requires the section 962 E&P (that is, amounts included under section 951(a) pursuant to a section 962 election) to be included in income by the individual U.S. shareholder when actually distributed. To implement that rule, the regulations describe two categories of section 962 E&P. The first category is excludable section 962 E&P (section 962 E&P equal to the amount of U.S. tax previously paid on amounts that the individual included in gross income under section 951(a)). The second is taxable section 962 E&P (the amount of section 962 E&P that exceeds excludable section 962 E&P).²⁴

Functional Example of Section 962

The three general tax consequences of making a section 962 election are illustrated in the following example.

A German CFC is wholly owned by one U.S. individual. That individual makes a timely section 962 election. During year one, the CFC earns US \$1 million of subpart F income and pays US \$300,000 in income taxes to the German tax authorities. The CFC makes no actual distributions during year one. Under section 962, the individual includes the US \$1 million of subpart F income in his gross income and claims an indirect foreign tax credit for the US \$300,000 of foreign income tax paid by the CFC. If the U.S. corporate income tax rate were 35 percent, the individual would pay US \$50,000 in U.S. income tax (that is, US \$350,000 of tax minus the US \$300,000 indirect foreign tax credit).

During year two, the CFC distributes US \$700,000 to the individual. Because that US \$700,000 is considered section 962 E&P, the individual must include US \$650,000 in income (that is,

¹⁸S. Rep. No. 1881, 87th Cong. 2d Sess. 92 (1962), reprinted at 1962-3 CB 703, 798.

¹⁹Making a section 962 election may be beneficial or detrimental to an individual depending on the circumstances. See Lawrence A. Pollack, "Individual Investors in CFCs May Benefit From Electing to be Taxed as Corporations," 81(2) *Journal of Taxation* 112 (Aug. 1994); Boris I. Bittker and Lawrence Lokken, *Fundamentals of International Taxation*. Warren, Gorham & Lamont, 2002, pp. 69-77 to 69-79; Laraine S. Rothenberg, *Subpart F — Sections 954-964, 1248 and Related Provisions*, BNA Portfolio 930-1st, pp. 49-50.

²⁰Section 962(a)(1); Treas. reg. section 1.962-1(a)(1).

²¹Section 962(a)(2); Treas. reg. section 1.962-1(a)(2).

²²Section 962(d); Treas. reg. section 1.962-3.

²³Section 959(a)(1).

²⁴Treas. reg. section 1.962-3(b)(1).

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the taxable section 962 E&P; US \$700,000 dividend minus the US \$50,000 of tax paid as a result of making the section 962 election). Moreover, assuming a U.S. individual income tax rate of 35 percent, the individual must pay an additional US \$227,500 in tax (that is, US \$650,000 multiplied by 35 percent).

Over the two-year period, the individual pays a total of US \$277,500 in U.S. tax (that is, US \$50,000 in year one plus US \$227,500 in year two). If the individual had decided not to make a section 962 election, in year one he would have included US \$700,000 of subpart F income in gross income and would have paid only US \$245,000 in U.S. income tax (that is, US \$700,000 multiplied by 35 percent). In this example, the individual U.S. shareholder ends up paying an additional US \$32,500 in U.S. tax because of his decision to make a section 962 election.

If an individual would be obligated to pay more in U.S. taxes by making a section 962 election, why would he do so voluntarily? The answer is easy — deferral. If the CFC does not actually distribute the funds for several years, the additional US \$32,500 of tax caused by making the section 962 election may be less than the amount that the individual can earn on the US \$227,500 that he is able to defer paying to the IRS.

JGTRRA and Tax Treatment of Actual Distributions Under Section 962

With the enactment of JGTRRA, an important issue is whether the actual dividend from the CFC of section 962 E&P is eligible for QDI treatment. Referring to the above example, the issue is whether the US \$650,000 (that is, US \$700,000 actual dividend minus the US \$50,000 of tax that the individual paid as a result of making the section 962 election) that the individual shareholder must include in income during year two is taxed as QDI at a rate of 15 percent or as non-QDI at a rate of 35 percent.

If the actual dividend is considered QDI, the individual U.S. shareholder may significantly reduce his tax liability. His U.S. income tax liability may be reduced from US \$245,000 (assuming he does not make a section 962 election; US \$700,000 multiplied by 35 percent) to US \$147,500 (assuming he does make a section 962 election; US \$650,000 multiplied by 15 percent plus the US \$50,000 paid at the time of the subpart F inclusion). That represents a nearly 40 percent reduction in U.S. income tax for the individual and reflects the proper tax treatment such individual would receive if he invested in the same German CFC through a domestic corporation.

Section 962 E&P: QDI or Non-QDI?

Despite the clear congressional purpose for enacting section 962, section 962(d) does not state that

the actual distribution of section 962 E&P is included by the shareholder as a dividend. Rather, it provides that those earnings will be included in gross income, which is similar to the language in section 951(a). Therefore, based on the reasoning in Notice 2004-70 that inclusions under section 951(a) are not dividends, the IRS may argue that an actual distribution of section 962 E&P is also not a dividend and thus is not eligible for QDI treatment.

A decision of that nature would put U.S. individuals on unequal footing with domestic corporations doing business abroad. That decision would, in essence, cause individual U.S. shareholders making a section 962 election to be subjected to a higher overall tax burden. Moreover, the decision would not provide individual U.S. shareholders with the assurance that their tax burdens on those undistributed foreign earnings will be no larger than if they had invested through a domestic corporation. Accordingly, that decision would undermine the legislative intent of section 962.

If an individual would be obligated to pay more in U.S. taxes by making a section 962 election, why would he do so voluntarily?

In light of the uncertainty concerning the treatment of actual distributions of section 962 E&P, the U.S. individual investing in the German CFC described above could simply invest through a domestic C corporation to claim indirect foreign tax credits and ensure that he would receive QDI treatment for actual distributions made by the CFC through the domestic corporation. The individual should not be required to make that type of tax-based decision, however, because section 962 was enacted to allow the individual to invest directly in the German CFC and receive the same tax treatment that he would have received if he had invested indirectly through a domestic C corporation.

Section 962 and the Treaty Test

Assuming section 962 E&P is otherwise eligible for QDI treatment, one of the more perplexing issues raised by this discussion is whether a CFC with respect to which a section 962 election is made must be a QFC at all. As mentioned above, for a dividend from a foreign corporation to be eligible for QDI treatment, the foreign corporation must be a QFC. To be considered a QFC, the entity must meet many tests, including the so-called treaty test. The treaty test dictates that an entity is considered a QFC if it is eligible for the benefits included in a comprehensive income tax treaty with the United States; the U.S. Treasury Department determines that the treaty is satisfactory under JGTRRA; and the treaty

includes an exchange-of-information program.²⁵ The IRS has issued several notices on the treaty test. Among them is Notice 2003-69, which lists the countries that satisfy the treaty test and identifies four disfavored nations.²⁶

Referring to the situation above in which a U.S. individual owns shares in a German CFC, the issue arises whether an actual dividend of section 962 E&P is treated as being paid by a domestic corporation or a foreign corporation. If the dividend is treated as being paid by a domestic corporation, the QFC analysis is unnecessary.

For example, assume a CFC is incorporated in Iraq, a country that does not meet the treaty test. On one hand, if the Iraqi CFC were owned by a domestic corporation, the domestic corporation would receive the benefits of the indirect foreign tax credit provisions on subpart F inclusions. An individual U.S. shareholder of the domestic corporation would, in turn, enjoy QDI treatment for dividends that it received from the domestic corporation.

If the actual dividend is considered qualified dividend income, the individual U.S. shareholder may significantly reduce his tax liability.

On the other hand, if an individual U.S. shareholder invested directly in the same Iraqi CFC, that individual could make a section 962 election to be taxed at the corporate tax rates on the subpart F inclusions. Would a subsequent distribution of the section 962 E&P from the CFC be treated as being paid by a domestic corporation or a foreign/Iraqi corporation for QDI purposes? If the section 962 E&P is treated as being received from a domestic corporation, it shouldn't matter that the CFC is incorporated in a country that may or may not satisfy the treaty test. However, if the section 962 E&P is treated as being received from the foreign/Iraqi corporation, the CFC's country of incorporation remains highly relevant in determining whether to make a section 962 election.

In short, the issue is whether an individual U.S. shareholder who makes a section 962 election on the Iraqi CFC should receive the same QDI treatment on distributions of section 962 E&P as if he invested in the Iraqi CFC through a domestic corporation. If not, on what basis could that result be justified in light of the clear legislative intent underlying sec-

tion 962 that individuals investing abroad receive the same tax treatment as domestic corporations investing abroad?

Two critical points flow from the analysis. First, if the IRS were to conclude that distributions of section 962 E&P are eligible for QDI treatment but only if the CFC is a QFC, then the QDI benefits of making a section 962 election would be available only for individual U.S. shareholders of CFCs that are organized in U.S. possessions or in countries that satisfy the treaty test. Second, if the IRS were to conclude that distributions of section 962 E&P are eligible for QDI treatment regardless of whether the CFCs are organized in U.S. possessions or in countries that satisfy the treaty test, then the section 962 election becomes a more expansive planning tool for individual U.S. shareholders in CFCs that are organized in countries that impose an income tax of at least 15 percent.

In the latter case, the dilemma many practitioners will face is whether the section 962 election makes sense. That point is considered below.

When to Consider the Section 962 Election

A section 962 election shouldn't be taken lightly, particularly given the unresolved issues outlined above. For instance, if distributions of section 962 E&P do not constitute QDI, making a section 962 election could significantly increase an individual's effective U.S. income tax rate. Alternatively, if distributions of section 962 E&P do constitute QDI, not making a section 962 election can significantly increase an individual's effective U.S. income tax rate. The section 962 election not only allows taxpayers to defer payment of an amount of U.S. tax, but also, as illustrated in the example above, potentially reduces a taxpayer's U.S. income tax burden by 40 percent or more.

Assuming that section 962 E&P is eligible for QDI treatment and further assuming that section 962 E&P is treated as being received from a domestic corporation, tax practitioners should seriously consider recommending that a section 962 election be made even if a CFC's effective foreign income tax rate is reduced to a more modest 15 percent.

Returning to the example above and assuming a foreign tax rate of 15 percent, on making the section 962 election, the individual U.S. shareholder would include US \$1 million of subpart F income and claim a US \$150,000 indirect foreign tax credit during year one. Assuming that the U.S. corporate income tax rate is 35 percent, the individual would pay US \$200,000 of U.S. income tax (that is, US \$350,000 of tax minus a US \$150,000 indirect foreign tax credit).

During year two, the CFC distributes US \$850,000. Because the US \$850,000 is section 962 E&P, the individual includes US \$650,000 in income (that is, US \$850,000 distribution minus the US

²⁵Section 1(h)(11)(C)(i)(II).

²⁶Notice 2003-69, 2003-42 IRB 851 (Oct. 20, 2003).

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\$200,000 of U.S. tax paid as a result of making the section 962 election) and would pay an additional US \$97,500 in U.S. income tax, assuming the distribution is taxable as QDI at a 15 percent rate (that is, US \$650,000 multiplied by 15 percent). Thus, the total U.S. income tax would be US \$297,500.

If the individual did not make a section 962 election and included the subpart F income during year one, the US \$850,000 subpart F income inclusion would yield the same U.S. income tax liability of US \$297,500, assuming a 35 percent tax rate. Therefore, even though the ultimate U.S. tax liability is the same, the section 962 election should continue to make sense, if only to defer payment of US \$97,500 of U.S. income tax.

Practitioners obviously must run the calculations based on a CFC's effective foreign income tax rate and take into account any foreign tax credit limitations under section 904. Nonetheless, if section 962 E&P inclusions are eligible for QDI treatment, the section 962 election begins to make sense at much lower effective foreign income tax rates than in prior years.

Additional Issues Raised by Section 962 and The QDI Provisions

This analysis is not without further questions. For instance, if a distribution of section 962 E&P is treated as QDI paid by a domestic corporation rather than by a QFC, the foreign tax credit analysis may become more complicated. Would the dividend be considered foreign-source income when claiming a foreign tax credit for withholding taxes, or would the dividend be considered U.S.-source income? Does section 960(b) permit an adjustment in calculating the section 904 limitation? Are there any implications under section 904(c) now that foreign tax credit carrybacks are limited to one year?

Conclusion

After years of near dormancy, section 962 may be close to revival. However, before that may occur, the relationship between section 962 and JGTRRA must be clarified. Hopefully, the IRS will provide guidance on the issue soon to assist tax practitioners in advising their clients, particularly those individual clients who own stock in CFCs organized in countries that do not meet the treaty test. ◆