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H. David Rosenbloom

Jaehong Lee

H. David Rosenbloom is a member with Caplin & Drysdale Chtd. in Washington, director of the international tax program at New York University School of Law, and a member of Tax Analysts' board of directors. Jaehong Lee is an attorney with Kim & Chang in Seoul.

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In this article, the authors describe how the subpart F and global intangible low-taxed income rules affect the taxation of income of individual shareholders of controlled foreign corporations.

The Tax Cuts and Jobs Act has substantially changed the taxation of U.S. shareholders operating abroad through controlled foreign corporations by:

- expanding the definition of U.S. shareholder to include a U.S. person holding less than 10 percent of a CFC by vote but at least 10 percent by value;
- eliminating the requirement that a foreign corporation be a CFC for at least 30 days before there can be subpart F income taxable to U.S. shareholders;
- changing rules governing ownership by allowing attribution from some foreign persons to related U.S. persons; and
- introducing a novel concept — global intangible low-taxed income — with rules that impute a large portion of a CFC's active income to the U.S. shareholders.[1]

Three years into the GILTI rules, commentators have noted a shift from the preexisting deferral regime, which allowed CFC earnings to remain untaxed until distributed or otherwise made available in the United States, to a new set of rules under which most CFC earnings are taxed immediately or not at all, a sort of partial participation exemption. The comments pertain mostly to corporate shareholders, although even for them, the elimination of the preexisting deferral regime is incomplete. Some types of CFC earnings, having escaped immediate taxability to U.S. shareholders under both subpart F and the GILTI rules, do not qualify for exemption on distribution. Examples include distributions on shares held less than 12 months or that are made via hybrid dividends and are thus ineligible for the section 245A exemption.

For individual U.S. shareholders, an election under section 962 has long been available to compute tax on a subpart F inclusion as if a domestic corporation were inserted between the individual and the CFC. That makes the foreign tax credit available and allows for at least a modified deferral result, with immediate U.S. tax liability dependent on the amount of FTCs available. Another long-available deferral option is the section 954(b)(4) high-tax exception to subpart F that applies to CFC earnings subject to a

[1] Section 951A.

relatively high rate of foreign income tax. It is possible for a shareholder to elect both section 962 and the high-tax exception, but in practice those provisions generally function as alternatives.

Individuals are mostly forgotten in the international provisions of the TCJA, including the GILTI rules. Yet individual U.S. shareholders are subject to those rules, which treat them far more harshly than corporate shareholders. The section 962 election mitigates the harshness, and the regulatory decision to allow a section 250 deduction —part of the GILTI regime — when a section 962 election is made renders that election attractive. Section 962 is cumbersome, however, because it applies to all inclusions in a given year, under both subpart F and GILTI rules. There is essentially no cross-crediting of FTCs between subpart F and GILTI inclusions because GILTI has its own FTC limitation. So a section 962 election calls for separate analyses of subpart F and GILTI consequences.

For corporate shareholders, the high-tax exclusion from tested income shifts CFC earnings to income that is wholly exempt, both when earned and (generally) when distributed, and consequently offers the possibility of a beneficial shift in the application of allocable and apportionable deductions. For individual shareholders, the benefit of the high-tax exception from subpart F or the high-tax exclusion from tested income — besides indefinite deferral of U.S. taxation — is a large overall reduction in U.S. tax, as compared with the U.S. tax that would otherwise apply, assuming the CFC is located in a treaty partner jurisdiction. For both subpart F exception and GILTI exclusion purposes, the term "high tax" means in excess of 90 percent of the U.S. corporate tax rate, or 18.9 percent. That, or course, compares favorably with the top individual rate of 37 percent plus an additional 3.8 percent for the net investment income tax.

Both the section 962 election and the high-tax rules can be important for families owning active foreign corporations directly or through partnerships or S corporations. U.S. resident aliens can be U.S. shareholders, so those provisions are highly relevant when ownership of a foreign corporation shifts from a nonresident alien — say, a founder — to U.S. resident aliens such as the founder's children or spouse as a result of a bequest, gift, or change of residence.

For individuals contemplating immigration to the United States, the prospect of U.S. taxation of income not received in cash can be a strong deterrent. The need for tax distributions to pay U.S. tax on a CFC's earnings may be troubling and puts a premium on advance planning to insert shareholder debt that will allow for transfers of cash without tax. Sometimes an individual plans to remain in the United States for only a certain period before returning to her home country (although the period might not be known in advance, and she may decide to stay longer). Particularly in those cases, the section 962 election or the high-tax rules could prevent CFC earnings from being taxed by the United States at all, because the individual may be able to defer receiving distributions until returning to the home country.

The high-tax exclusion from tested income reflects an expansive reading of section 951A(c)(2)(i)(III) to the effect that high-taxed CFC income, including income that would not otherwise be foreign base company income or insurance income, may be excluded from tested income upon election by the U.S. shareholder. Importantly, a consistency requirement in the final high-tax exclusion regulations (T.D. 9902) and proposed regulations (REG-127732-19) for the high-tax exception rule of subpart F creates substantial friction affecting the decision whether to make the necessary election. The consistency requirement provides that election of high-tax treatment applies annually to all income of all CFCs whose stock is held by the U.S. shareholder. That means the election will apply for both subpart F and GILTI.

I. Workings of Subpart F Taxation

The overarching principles and mechanics of the taxation of individual U.S. shareholders under subpart F are well established, and the TCJA did not change the basic operation of preexisting law. U.S. shareholders must include annually their CFCs' foreign base company income and insurance income as if the income had been distributed.[2] Normal U.S. income tax rates apply

[2]Section 951(a).

— 21 percent for corporate shareholders and up to 37 percent for individual shareholders.

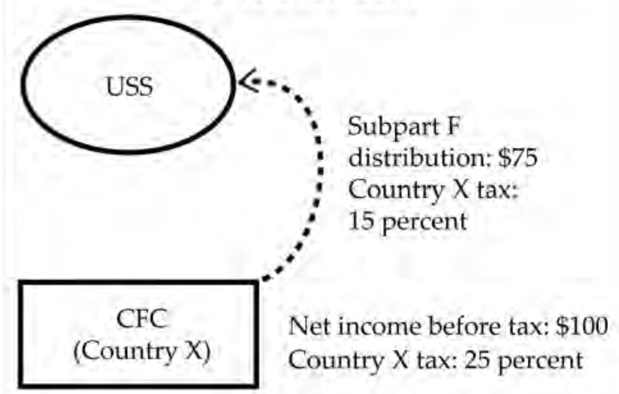
Section 954(b)(4), the subpart F high-tax exception to foreign base company income and insurance income, existed before enactment of the TCJA, and its text has not changed. The provision is elective because it depends on the taxpayer establishing its application, which the taxpayer might decide not to do. Pre-TCJA, the election resulted in deferral of subpart F income for the individual U.S. shareholder,[3] a result that was not remarkable because non-inclusion (deferral) depended on an effective foreign tax rate exceeding 31.5 percent when the corporate tax rate was 35 percent and the top individual rate was 39.6 percent. Thus, the corporate and individual rates were much closer than they are today. Moreover, few foreign countries had an effective rate exceeding 31.5 percent, so application of the subpart F high-tax exception was limited.

With the reduction of the corporate rate and commensurate reduction in the high-tax threshold from 31.5 percent to 18.9 percent, the high-tax exception to subpart F allows an individual shareholder to achieve a much lower rate than would apply to an immediate inclusion, which does not qualify for the lower rate of section 1(h)(11) applicable to qualified dividend income (QDI).[4] Many countries have effective tax rates higher than 18.9 percent.[5]

An example will illustrate how U.S. tax applies to the sole individual U.S. shareholder of a CFC in Country X, both without and with the section 954(b)(4) high-tax exception to subpart F income. For simplicity, the section 1411 net investment income tax of 3.8 percent is disregarded, and it is assumed that the CFC's income is in U.S. dollars and that the highest rate bracket of 37 percent applies.

In this base case, the hypothetical CFC earns net income before tax of $100 in year 1 and is taxed at a 25 percent rate by X. The income is entirely subpart F income, and in year 2 the CFC distributes its entire post-foreign-tax earnings of $75 to the shareholder. X imposes a 15 percent tax on the distribution (see figure.)

The Base Case



In year 1, the X income tax of $25 leaves $75 of income subject to subpart F and taxed at 37 percent ($75 * 37 percent = $27.75). Individual shareholders are not entitled to a section 960 deemed paid FTC, so the $25 of X tax cannot be credited, and there is no gross-up for the foreign tax, which is effectively deducted. In year 2, the CFC distributes $75 to the shareholder, and X imposes tax of $11.25 ($75 * 15 percent) on the distribution. The individual shareholder is not subject to further U.S. tax because the income was previously taxed by the United States and section 959(a) prevents it from being taxed again. The tax imposed by X on the distribution may be credited against the shareholder's U.S. tax by reason of section 960(c), which increases the shareholder's FTC limitation by the amount of the foreign tax.[6] On the assumed facts, the shareholder should be able to credit the $11.25 of tax, and the overall effective tax rate would be 52.75 percent (see Table 1).

[3] The regulations have historically made clear that the corporate rate is the appropriate index even for individuals, despite the inability of individuals to claim a deemed paid foreign tax credit. *See* Treas. reg. section 1.954-1(d)(1)(ii) and (3)(i). For discussion, see Section III, *infra.*

[4] Notice 2004-70, 2004-2 C.B. 724.

[5] According to 2019 OECD statistics, 45 foreign countries show effective average tax rates higher than 18.9 percent. That is compared with 2017, when only six foreign countries were above the then-high-tax threshold of 31.5 percent. OECD, "Effective Tax Rates" (last visited July 9, 2020).

[6] That assumes the subpart F inclusion and the foreign tax imposed on the distribution fall in the same FTC limitation, an assumption supported by Treas. reg. section 1.904-6(b).

Table 1. Effective Tax Rate of Income Subject to Subpart F Taxation Without High-Tax Exception

Year 1	
Country X income tax on CFC	$100 * 25% = $25
Subpart F taxation of the individual U.S. shareholder	$75 * 37% = $27.75
Year 2	
Country X tax on distribution	$75 * 15% = $11.25
No additional U.S. income tax because distribution is from previously taxed earnings and profits	
Section 960(c) foreign tax credit for Country X tax on the distribution	(-) $11.25
Total Effective Tax Rate:	($25 + $27.75 + $11.25 - $11.25) / $100 = 52.75%

Table 2. Effective Tax Rate of Income Subject to Subpart F Taxation With High-Tax Exception

Year 1	
Country X income tax on CFC	$100 * 25% = $25
No subpart F income because of section 954(b)(4)	
Year 2	
Country X tax on the distribution	$75 * 15% = $11.25
Qualified dividend income	$75 * 20% = $15
Foreign tax credit for Country X tax on the distribution	(-) $11.25
Total Effective Tax Rate	($25 + $15 + $11.25 - $11.25) / $100 = 40%[a]
[a]At a foreign tax rate just sufficient to constitute "high tax," the overall effective rate would be 35.12 percent (18.9 + (20% * 81.1 = 16.22)).	

Because the CFC's income was subject to X income tax at a rate of 25 percent — in excess of 90 percent of the U.S. corporate tax rate of 21 percent — the individual U.S. shareholder can elect under section 954(b)(4) to except the CFC earnings from subpart F. If the shareholder so elects, she would not include the CFC's subpart F income in her U.S. income, and no distribution would be deemed to occur. In turn, no distributed CFC earnings would be previously taxed earnings and profits under section 959(a). The shareholder would pay U.S. tax only when the CFC's earnings are repatriated to her. If X is a U.S. treaty partner, the favorable 20 percent tax rate for QDI under section 1(h)(11) would apply to the repatriation, lowering the overall effective rate. With an FTC for the X tax on the distribution, the total effective tax rate would be 40 percent (see Table 2).

Year 2 taxes are incurred only if and when the CFC declares a distribution. As long as the earnings remain with the CFC, year 2 taxes can be indefinitely deferred.

An election under section 962 would produce the same outcome. The individual shareholder would report an inclusion as if she held shares in the CFC through a domestic corporation. Congress enacted section 962 to ensure that an individual's tax burden on undistributed foreign earnings of a CFC will be no heavier than it would have been had she invested in a U.S. corporation doing business abroad.[7] That, in turn, permits the shareholder to claim the section 960 deemed paid FTC. Any subsequent distribution, however, would be subject to tax if it exceeds the U.S. tax paid on the subpart F inclusion, because only the amount of that tax is treated as previously taxed E&P by reason of section 962(d).

If the individual shareholder made a section 962 election, she would include subpart F income in year 1 subject to the 21 percent corporate tax rate, but the FTC would fully shelter the income from U.S. tax because the tax paid to X is greater than the U.S. corporate tax. In year 2, when the CFC distributes its entire post-foreign-tax earnings, the shareholder would be taxed on the distribution if it exceeds the amount of U.S. tax paid on the subpart F inclusion — zero. If the distribution is foreign-source income from a treaty partner jurisdiction and the 20 percent rate applies to the QDI, the effective tax rate would be 40 percent (see Table 3).

[7]S. Rep. No. 1881, at 798 (1962).

Table 3. Effective Tax Rate of Income Subject to Subpart F Taxation With Section 962 Election

Year 1	
Country X income tax on CFC	\$100 * 25% = \$25
Subpart F taxation with section 960 credit applied	\$100 (\$75 + \$25 gross-up) * 21% - \$25 = 0[a]
Year 2	
Country X tax on the distribution	\$75 * 15% = \$11.25
Tax on the actual distribution	(\$75 - 0) * 20% = \$15
Foreign tax credit	(-) \$11.25
Total Effective Tax Rate	(\$25 + \$11.25 + \$15 - \$11.25) / \$100 = 40%

[a]The excess credit can be carried over to other years in which section 962 is elected. Treas. reg. section 1.962-1(b)(2)(iii).

The U.S. Tax Court's decision in *Smith v. Commissioner*, 151 T.C. 41 (2018), makes clear that a section 962 election can be a questionable choice in some circumstances. The taxpayer elected section 962 for a wholly owned Hong Kong CFC. He argued that section 962 effectively meant that the dividend distribution he received came from a U.S. corporation — an entity conceptually interposed between the CFC and the shareholder — and thus qualified for the section 1(h)(11) beneficial rate on QDI. The court rejected that proposition, saying the taxpayer argued "that what section 962 pretends to have occurred actually happened," for which it found no basis in either section 962 or section 1(h)(11). The court held that the distribution to the taxpayer was a distribution of the foreign corporation's E&P, not the E&P of a domestic corporation. Because Hong Kong is not a treaty jurisdiction, the consequences were that section 1(h)(11) did not apply and the taxpayer was required to again recognize earnings that had been included under subpart F less the U.S. tax paid on the subpart F inclusion. "Unfortunately that is sometimes how the cookie crumbles," the court said.

At the corporate rate of 21 percent and top individual rate of 37 percent, and assuming the CFC's foreign tax rate is zero, a *Smith* analysis results in a taxpayer paying U.S. tax of 50.23 percent on a CFC's earnings — 21 percent on the subpart F inclusion and 29.23 percent (0.37 * (\$100 - \$21)) on the distribution, as opposed to 37 percent if there had been no section 962 election. Had the taxpayer in *Smith* prevailed on the QDI issue, or had the CFC been a resident of a treaty partner jurisdiction, total U.S. tax would have been at an effective rate of 36.8 percent — 21 percent on the subpart F inclusion plus 15.8 percent (0.2 * (\$100 - \$21)) on the distribution.[8]

It is unclear why the taxpayer in *Smith* elected section 962: There appear to have been no FTCs to claim. In those circumstances the election makes sense only if the strategy is to achieve deferral in return for an immediate 21 percent tax. The distribution received by the taxpayer served to undermine that strategy.

The cookie may crumble differently when a CFC has paid substantial foreign tax and is a resident of a treaty partner jurisdiction, and the taxpayer, relying on *Smith*, maintains that the distribution from the CFC represents foreign-source income. If there is an FTC to shield the subpart F inclusion from U.S. tax, the total U.S. tax is only the 20 percent on the distribution.[9] It has never been possible, however, to elect section 962 for subpart F inclusions from only some CFCs. And the TCJA makes clear that the election covers not only inclusions under section 951 but GILTI inclusions under section 951A as well.

II. Workings of GILTI Taxation

As described above, the TCJA drastically expanded the taxation of a CFC's active income by introducing the GILTI regime. That requires a U.S. shareholder of a CFC to include GILTI in gross income, effectively shifting the taxation of much non-subpart F income of CFCs from traditional deferral to immediate taxation. A U.S. shareholder calculates its GILTI inclusion by aggregating tested income and losses of all the CFCs and subtracting its net deemed tangible

[8]With a section 962 election, those effective rates — 50.23 percent if QDI does not apply, 36.8 percent if it does — are the same with no FTCs or any FTCs up to the 21 percent limitation. However, FTCs mean that the corporate tax take is shared between the United States and a foreign country or countries. Of course, higher rates of foreign tax raise the overall effective rate.

[9]The section 78 gross-up is a dividend "for purposes of this title," but it has the effect on the amount of the distribution to the shareholder.

income return — equal to 10 percent of the qualified business asset investment of CFCs with positive tested income — less specific allocated interest expense. A CFC's tested income begins with its gross income but excludes specified categories of income, including gross income subject to the subpart F regime and gross income excluded from that regime "by reason of section 954(b)(4)."

To avoid harming the competitive position of U.S. corporations relative to their foreign peers, U.S. corporate shareholders are entitled to deduct 50 percent (37.5 percent after 2025) of the sum of the GILTI inclusion plus the section 78 foreign tax gross-up. That results in an effective U.S. rate of 10.5 percent for U.S. corporate shareholders. Individual U.S. shareholders are not entitled to either the section 250 deduction or the section 960 deemed paid FTC.

The fact patterns in the base case discussed can be used to illustrate the foregoing points, on the assumptions that the CFC's income is tested income rather than subpart F income and there is zero QBAI (it is also assumed that the shareholder is not a shareholder of other CFCs). If the individual U.S. shareholder does not elect either the high-tax exclusion or section 962, she would have net tested income of $75 in year 1 and, because she is not entitled to a section 250 deduction, the GILTI inclusion would be $75, resulting in $27.75 ($75 * 0.37) of U.S. tax. Because the deemed paid FTC is unavailable and there is no gross-up, that tax would be paid in addition to the CFC's Country X income tax of $25. In year 2 when the CFC distributes its entire after-foreign-tax earnings of $75 to the shareholder, X would impose a withholding tax of $11.25 ($75 * 0.15), and no additional U.S. tax would be imposed for the same reason as in the repatriation of subpart F income.[10] For crediting the X tax on the distribution, although section 951A(f)(1) does not expressly refer to section 960(c) as adapted for a GILTI inclusion, regulations prescribe that an amount included in gross income under section 951A(a) is treated as an amount included in gross income under section 951(a).[11] Assuming the section 960(c) limitation is a GILTI limitation capable of absorbing the credit for the foreign tax on the distribution, the resulting overall effective tax rate would be 52.75 percent (see Table 4).

Table 4. Effective Tax Rate of GILTI Without High-Tax Exclusion

<u>Year 1</u>	
Country X income tax on CFC	$100 * 25% = $25
GILTI taxation of the individual U.S. shareholder	$75 * 37% = $27.75
<u>Year 2</u>	
Country X tax on the distribution	$75 * 15% = $11.25
Section 960(c) foreign tax credit for the tax on the distribution	(-) $11.25[a]
The distribution is from previously taxed earnings and profits so there is no additional U.S. income tax	
<u>Total Effective Tax Rate</u>	($25 + $27.75 + $11.25 - $11.25) / $100 = <u>52.75%</u>

[a]There are some mysteries here. First, it is not clear that the FTC for the foreign tax on the distribution falls in the separate FTC limitation for GILTI, although that would seem to be the appropriate result under the principles of Treas. reg. section 1.904-6. However, is the increase in limitation envisioned by section 960(c) a GILTI limitation? That would also seem appropriate, but might a refund then be available under section 960(c)(5)? Curiously, the 20 percent reduction in the amount of foreign tax that qualifies for the GILTI FTC does not apply to the foreign tax on the distribution. *See* section 960(d)(1).

III. Applying the High-Tax Exclusion

As mentioned, individual U.S. shareholders may benefit from deferral treatment for tested income using the high-tax exclusion found by regulatory interpretation of section 951A(c)(2)(A)(i)(III). The plainest reading of the statute is that tested income excludes income that would otherwise be subpart F income, but the regulations interpret the statute as encompassing all high-tax income regardless of whether it would be subpart F income if taxed at a lower foreign rate. On the other hand, the regulations leave unclear whether an individual U.S. shareholder is eligible for the exclusion in the first

[10]Sections 959(a) and 951A(f).

[11]Treas. reg. section 1.960-4(a)(1).

place. The subpart F and GILTI high-tax rules apply to U.S. shareholders of CFCs by reference to high rates of creditable foreign taxes under the section 960 regulations, with no express statements regarding individual shareholders. Because section 960 does not normally apply to individuals, the cross-reference could suggest that individuals are ineligible for the exclusion. The issue was highlighted when the proposed GILTI high-tax exclusion regulations modified the first sentence of reg. section 1.954-1(d)(3)(i) by removing the following parenthetical: "(determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made)." The revised first sentence of reg. section 1.954-1(d)(3)(i) simply cross-references the section 960 regulations (reg. section 1.960-1(d)(3)(ii)), which do not by their terms apply to individual shareholders.

It is doubtful that a negative inference should be drawn from the removal of the parenthetical, which has not been explained. Although the removal makes it impossible to confirm the availability of the high-tax exception from subpart F or the high-tax exclusion from tested income for an individual who has not made a section 962 election, denial of that availability would represent a substantial change in preexisting law. Section 954(b)(4) contemplates that the high-tax exception to subpart F is available for all U.S. shareholders without regard to creditability under section 960. The regulations say the exception is available on election by "controlling United States shareholders," a term that includes individual U.S. shareholders. That the election is binding on all U.S. shareholders also suggests that an individual U.S. shareholder should be entitled to the high-tax exception.

The downside of the high-tax exclusion for tested income is that it cannot be made for only a select number of CFC operations; instead, it must apply to any and all CFC tested units that meet the high-tax test and must apply for the subpart F exception as well. This rule of consistency will require paying close attention to the opportunities for cross-crediting when there is both high- and low-taxed tested income funneling into GILTI. Although tax returns may be amended to reflect a change of facts regarding tested income after a return is filed, amendments require the consent of all U.S. shareholders and can be made for only a 24-month period. The high-tax exclusion is elected annually.

IV. The Exclusion's Effects on U.S. Shareholders

The benefits of the high-tax exclusion are different for an individual shareholder than for a corporate shareholder. The corporate shareholder is likely to benefit from a shift of allocable and apportionable deductions away from the GILTI FTC limitation and their application to reduce other income, including domestic income.[12] The individual shareholder, on the other hand, benefits from the elimination of mandatory current taxation and the possibility of a sharp reduction in total taxation when the income in question is distributed, assuming the distribution is from a treaty partner jurisdiction. As noted, the individual U.S. shareholder is entitled to the high-tax exclusion even though the rate threshold is only about 50 percent of the maximum individual rate of 37 percent.

If the individual shareholder in the base case elected the high-tax exclusion, she could defer U.S. taxation indefinitely, meaning that in year 1 there is no U.S. tax, leaving only the $25 of Country X tax on the CFC's income. Deferral continues as long as post-foreign-tax earnings are retained by the CFC, as in the case of subpart F income. If the CFC's entire after-foreign-tax earnings are distributed in year 2, X will impose a tax of 15 percent ($11.25) on the distribution. If the distribution is from a treaty partner jurisdiction, a 20 percent tax rate for QDI will apply under section 1(h)(11). The overall effective tax rate will be 40 percent (see Table 5).

In view of the high-tax exclusion, the taxpayer's position is unaffected by the GILTI rules. Distribution of the CFC's income will fall in the FTC limitation category determined by applying the look-through rule of section 904(d)(3)(D) and Treas. reg. section 1.904-5. The foreign tax imposed on the distribution should accord with the categorization of the income under Treas. reg. section 1.904-6.

[12]For further explanation on the fundamental interactions of how the U.S. FTC regime and the participation exemption regime operate, see H. David Rosenbloom, "The U.S. Foreign Tax Credit Limitation: How It Works, Why It Matters," *Tax Notes Int'l*, Mar. 9, 2020, p. 1069.

Table 5. Effective Tax Rate of GILTI With Election of High-Tax Exclusion

Year 1	
Country X income tax	$100 * 25% = $25
No GILTI because of the election	
Year 2	
Country X tax on distribution	$75 * 15% = $11.25
Qualified dividend income of the shareholder	$75 * 20% = $15
Foreign tax credit	(-) $11.25
Total Effective Tax Rate	($25 + $11.25 + $15 - $11.25) / $100 = 40%

V. Effects of the Section 962 Election

An individual shareholder with a GILTI inclusion might also consider the section 962 election, as in the case of subpart F income.

As noted, section 962 is a comprehensive election and applies to all amounts under both sections 951 and 951A.[13] In addition to an inclusion bearing high foreign tax as described in the example, the taxpayer may face inclusions of low-tax income (under either subpart F or the GILTI rules), such as the inclusion involved in *Smith*. In those circumstances, the cross-crediting possibilities may be tempting but will need careful evaluation. As noted, there is essentially no opportunity for cross-crediting between subpart F inclusions and GILTI because GILTI credits generally fall in a separate FTC limitation.

The high-tax exception to subpart F and the high-tax exclusion from tested income cover only high-tax income, so a different evaluation of circumstances is required for section 962. The election of section 962 is annual and made on the taxpayer's return for the year it applies to.[14] There is no special rule regarding amendments of a return to make a section 962 election, nor any rule regarding the later unmaking of an election once it has been made in accordance with the regulations.[15]

Like the high-tax exclusion from tested income, section 962 is not all that flexible — but its inflexibility is different from that of the high-tax election. Section 962 covers all income of all CFCs of which the shareholder is a U.S. shareholder, while the high-tax election covers all high-tax income of CFCs and units of CFCs.

Once the high-tax exclusion from tested income is elected, GILTI does not enter into the analysis, and there can be no question that a distribution from the CFC has a foreign source. The situation for the section 962 election is not quite that clear. If the individual U.S. shareholder invokes the section 962 election, she can deduct 50 percent of any GILTI inclusion under section 250 and credit 80 percent of the Country X tax against grossed-up GILTI. On the facts of the base case, there is no residual U.S. tax and no carryover. However, neither the source of the eventual distribution nor the classification of the distribution and the X tax that applies to it is firmly settled.

Treas. reg. section 1.904-6 provides that "taxes are related to income if the income is included in the base upon which the tax is imposed." That means that regardless of the classification of the distribution and the foreign tax on the distribution (which will be a dividend in its entirety because in the base case there is no U.S. tax paid on the GILTI inclusion), an FTC should be available as long as the foreign source of the dividend is assured. The *Smith* court found that the distribution there came from the foreign corporation's earnings. That decision was not, however, focused on source, and the result of

[13] Treas. reg. section 1.962-1(a)(1) states that once a section 962 election is made, the tax imposed under section 11 would be "on all amounts which are included in his gross income for such taxable year under section 951(a)." Recently finalized Treas. reg. section 1.962-1(b)(1)(i)(A)(2) states that the inclusion amount (as defined in section 1.951A-1(c)(1)) for the tax year must be added to the calculation of taxable income along with "all amounts required to be included in his gross income under section 951(a) for the taxable year with respect to a foreign corporation of which he is a United States shareholder." Because the regulations do not bifurcate the calculation for deriving the taxable income subject to section 11, the best analysis would be that the section 962 election is applied uniformly on all inclusions under sections 951(a) and 951A. That analysis is also supported by the final regs' reference to the availability of section 250 deductions, which are added to the sum of the allowed deductions that would be deducted from the sum of the inclusion amounts stated above. Treas. reg. section 1.962-1(b)(1)(i)(B)(3).

[14] Treas. reg. section 1.962-2(b).

[15] See *Dougherty v. Commissioner*, 60 T.C. 917 (1973), in which the Tax Court accepted a first election on an amended return despite a regulatory requirement that the election be filed with the taxpayer's return.

Table 6. Effective Tax Rate of GILTI With Section 962 Election

Year 1	
Country X income tax on CFC	$100 * 25% = $25
GILTI taxation	0
• Net tested income	$75
• Section 78 grossed-up GILTI	$100
• GILTI after section 250 deduction	$50
• GILTI taxation	$50 * 21% = $10.5
• Section 960 deemed paid credit with 20% haircut	$25 * 80% = $20
• Residual U.S. tax	0[a]
Year 2	
U.S. tax on actual distribution from CFC	$75 * 20% = $15
Country X tax on the distribution	$75 * 15% = $11.25
Foreign tax credit	(-) $11.25[b]
Total Effective Tax Rate	($25 + $11.25 + $15 - $11.25) / $100 = 40%[c]

[a]There is no carryover for foreign taxes associated with GILTI.

[b]This makes the same assumptions about section 960(c) identified previously in Table 4, note a.

[c]With a foreign tax of 13.125, exactly the amount that always zeroes out U.S. corporate tax, the total effective rate is 30.5 percent (13.125 + (20% * 86.875 = 17.375)).

foreign sourcing of the distribution is far more favorable following a section 962 election than it would have been if the taxpayer in the example had inserted an actual U.S. corporation between herself and the CFC. Perhaps that, too, is simply how the cookie crumbles.

Assuming a taxpayer-favorable reading of *Smith* on the sourcing issue, the result in the example should be as shown in Table 6.

That is the same result that would apply under the high-tax exclusion.

VI. Conclusion

The high-tax exclusion represents an attractive alternative to the section 962 election in some circumstances. It would, for example, allow for complete exclusion of high-taxed tested income on which there would otherwise be U.S. tax. The U.S. shareholder will, however, want to consider carefully whether, on her facts, the high-tax exclusion from tested income represents the better choice. There may be situations when the availability of the section 250 deduction and deferral or the possibility of applying credits for high taxes against low-tax income would point toward section 962. ■