IRS Regulations Clarify GILTI Tax Relief to US Individual Shareholders with the Sec. 962 Election

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One of the many goals of US tax reform implemented by the Tax Cuts and Jobs Act of 2017 ("The Act") was to incentivize large multi-national enterprises that were perceived to be storing profits offshore to bring those profits back to the United States to create jobs and growth. Accordingly, the Act introduced a carrot, a "participation exemption" system, whereby US corporations owning controlled foreign corporations ("CFCs") could repatriate profits tax efficiently. The Act also contained a "stick," a new category of income called global intangible low-taxed income ("GILTI"). GILTI is included in the US shareholder's federal gross income under new Code Section 951A, with a 50% deduction to arrive at a 10.5 percent effective rate on GILTI. Under Section 250(a)(1), the 50% GILTI deduction is only available to "a domestic corporation for any taxable year." As a result, US individual shareholders with GILTI are not able to claim the deduction meaning that GILTI in their hands is taxed at federal rates of up to 37%.

To mitigate this negative result, many US individual shareholders of CFCs considered making an election under Code Section 962 to be treated as US corporations for GILTI tax purposes. Under the plain language of the Statute, it was unclear if electing US individuals could successfully claim the deduction under Code Section 250(a)(1). On March 4, 2019, the IRS issued proposed regulations clarifying that US individual shareholders making a Section 962 election are eligible for the same 50% deduction as US corporate shareholders.

The Section 962 election provides three main benefits to US individual shareholders of CFCs. First, it helps US individuals lower their tax bills because the deduction effectively lowers the federal tax rate form the top marginal individual rate of 37% to 10.5%. Additionally, applying foreign tax credits could significantly reduce or eliminate the GILTI tax. Second, it obviates the need for individual shareholders of CFCs to implement a business restructuring, such as transferring the CFCs to a US domestic corporation, which may result in unfavourable tax consequences in the CFC's home country. Third, it helps simplify the US shareholder's tax reporting obligations as he or she can still file a US individual tax returns rather than a more complicated US corporate tax return.

That said, US individuals considering making the Section 962 election should understand the administrative requirements of timely electing or revoking the election. Going forward, they must be mindful of tax consequences of future distributions, coordination with the deemed repatriation transition tax, and annual record keeping requirements. Also, for US individuals who are also residents of Canada, such persons will need to carefully work through any possible double tax implications of the GILTI with or without the Section 962 election.

While the proposed regulations provide welcome clarity for US individual shareholders of CFCs, the Section 962 election involves more complexity for US individuals in managing their US tax reporting obligations.