



March 11, 2021

Ms. Holly Porter
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Passthroughs & Special Industries
Internal Revenue Service
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Washington, DC 20224

Mr. Samuel P. Starr
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Internal Revenue Service
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Washington, DC 20224

RE: Global Intangible Low-Taxed Income (GILTI) Applied to Domestic Passthrough Entities under Subchapter K and Subchapter S

Dear Ms. Porter and Mr. Starr:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) in developing and requesting comments under section 951A,¹ Global Intangible Low-Taxed Income (GILTI), as applied to passthroughs.

The comments below provide additional information to Treasury and the IRS regarding our recommendations regarding the application of GILTI to partnerships and S corporations. The letter is comprised of three parts:

- A. [Notice 2020-69](#)
- B. GILTI Applied to Partnerships
- C. GILTI Applied to S Corporations
 - 1. S Corporation Not Electing Entity-Level Treatment (Default – Aggregate)
 - 2. S Corporation Electing Entity-Level Treatment

Also, Part C contains an additional consideration to allow an entity-level S corporation section 962 election (and entity treatment) in conjunction with our recommendation to allow an S corporation to elect entity-level treatment.² In summary, the AICPA concurs with Treasury and the IRS that the aggregate method is appropriate for passthroughs generally. However, Treasury and the IRS

¹ Unless otherwise indicated, references to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and references to a “Treas. Reg. §” are to the Treasury regulations promulgated under the Code.

² This additional consideration is not an official recommendation; however, it would lend itself as a logical extension of the official recommendations listed in Part III.

should accept our recommended alternatives to simplify reporting for S corporations and shareholders.

The AICPA is the world's largest member association representing the CPA profession, with more than 431,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Sarah Allen-Anthony, Chair, AICPA Partnership Taxation Technical Resource Panel, at (574) 235-6818 or Sarah.Allen-Anthony@crowe.com; Robert Keller, Chair, AICPA S corporation Taxation Technical Resource Panel, at (504) 584-1030 or rkeller@kpmg.com; David Sites, Chair, AICPA International Tax Technical Resource Panel, at (202) 861-4104 or David.Sites@us.gt.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204 or Alexander.Scott@aicpa-cima.com; Amy Miller, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9264 or Amy.Miller@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,



Christopher W. Hesse, CPA
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American Institute of CPAs

Global Intangible Low-Taxed Income (GILTI) Applied to Domestic Passthrough Entities under Subchapter K and Subchapter S

March 11, 2021

BACKGROUND

Section 951A,³ commonly known as GILTI, implements a tax on global low taxed income and generally requires U.S. shareholders⁴ of any controlled foreign corporation (CFC) to include in income the amount of GILTI for that year, also referred to as a GILTI inclusion amount. Section 951A is calculated at the shareholder level, and “employ[s] the basic subpart F architecture in several regards, such as for purposes of determining a U.S. shareholder’s pro rata share of tested items.”⁵ The final GILTI regulations addressed⁶ the determination of pro-rata shares of income inclusions, but the regulations did not completely address their application to passthrough entities. The regulations generally adopted an aggregate approach for both partnerships and S corporations; however, due to how those entities are treated for U.S. tax purposes, the “basic subpart F architecture,” without modification, is not an adequate foundation for GILTI taxation.

On September 8, 2020, Treasury and the IRS released [Notice 2020-69 \(the Notice\)](#). The Notice announced the intention to issue regulations pertaining to certain S corporations. The Notice also contained an irrevocable election for certain S corporations with accumulated earnings and profits (AE&P) to elect entity-style treatment,⁷ whereby GILTI inclusions are determined at the corporate-level, and each shareholder must take its respective pro-rata share of the GILTI inclusion into income.

A. Notice 2020-69

Overview

Under the current GILTI regime, the general aggregate method provides that each S corporation shareholder determines its GILTI inclusion amount at the shareholder level. However, the Notice provides that certain S corporations with transition AE&P may elect entity-level GILTI inclusions. Absent an election by the S corporation under the Notice, the S corporation is required to apply the aggregate treatment.⁸ The S corporation⁹ must make this election by attaching a statement to its timely filed (including extensions) original tax return for a tax year ending after September 1, 2020, and satisfy the following requirements:

³ Passed as part of the 2017 Tax Cuts and Jobs Act (TCJA).

⁴ A U.S. shareholder for GILTI purposes is a U.S. person who owns, directly, indirectly, or constructively at least 10% of the CFC stock.

⁵ [T.D. 9866](#), Preamble at VII C.

⁶ [T.D. 9866](#).

⁷ The Notice and other commentary also refer to entity treatment as the hybrid treatment method. The below comments and recommendations are based on a pure entity method without regard to existing AE&P.

⁸ Under Treas. Reg. § 1.951A-1(e).

⁹ The S corporation must have elected S status before June 22, 2019.

1. Is otherwise treated as owning stock, within the meaning of section 958(a), of a CFC on June 22, 2019;
2. Has elected S corporation status before June 22, 2019;
3. Has transition AE&P on September 1, 2020,¹⁰ or on the first day of any subsequent tax year; and
4. Maintains records supporting the S corporation's determination of transition AE&P.¹¹

Further, once an S corporation reduces its transition AE&P to zero, it must apply the aggregate method prospectively.

Recommendation

The AICPA respectfully requests Treasury and the IRS provide appropriate transition rules for taxpayers having made the irrevocable election when further guidance is published, in conjunction with our recommendations in Part III regarding S corporations.

Analysis

The irrevocable election is a significant concern for practitioners and taxpayers who make a good-faith attempt to apply the current rules. However, because no proposed regulations have been published that specifically target the accumulated adjustments account (AAA) and how GILTI inclusions may or may not affect those adjustments, practitioners and taxpayers are unclear about what they are electing into.

Good tax policy relies on fairness and transparency. S corporations (and their shareholders) that in good faith make an irrevocable election under the Notice should receive protection with appropriate transition rules in case forthcoming regulations differ from the Notice. An immediate announcement by Treasury and the IRS to this effect would provide taxpayers confidence to appropriately analyze and possibly make this election. There are numerous elections in the international context that are made on a year-by-year basis. There is significant complexity in applying rules that lack detailed provisions regarding application to domestic entities under subchapters K and S.

B. GILTI Applied to Partnerships

Overview

Under Treas. Reg. § 1.951A-1(e)(1), for purposes of calculating GILTI inclusions under section 951A, domestic partnerships should have treatment in the same manner as foreign partnerships under section 958(a)(2). Accordingly, a domestic partnership is not treated as owning stock of a foreign corporation, but instead the owners of the partnership are required to take into account

¹⁰ Transition AE&P is calculated as of September 1, 2020 and is reduced by dividends distributed after that date. Transition AE&P cannot be increased and is nontransferable.

¹¹ The statement is attached to the Form 1120S, *U.S. Income Return for an S Corporation*. Special and detailed rules apply for S corporation years that end before September 1, 2020.

each GILTI tested item in accordance with each owner's proportionate ownership of CFC stock and the pro-rata share rules. Under Treas. Reg. § 1.958-1(c)(2), for purposes of determining the amount of stock owned, a partner's proportionate ownership of CFC stock is determined based on all the facts and circumstances and should be calculated in a manner that is consistent with the purpose of the calculation.

Recommendations

The AICPA recommends that Treasury and the IRS clarify that in applying Treas. Reg. § 1.958-1(c)(2) to the allocation of GILTI tested items under Treas. Reg. § 1.951A-1(e)(1), the determination of a partner's proportionate share of CFC stock must be determined in a manner consistent with how the CFC stock would be distributed to the partners upon a hypothetical liquidation of the partnership. How the CFC stock is actually distributed is not easily determined in all cases. Therefore, one approach that appears administrable is to provide that partnerships may assume, for this purpose, that the CFC stock is distributed in the same manner that dividends or gain on sale of the stock is allocated under section 704(b) principles.

The AICPA also recommends that Treasury and the IRS provide rules for the partnership level tracking of previously taxed earnings and profits (PTEP) related to GILTI inclusions by its partners, including the effect of PTEP on the partnership level characterization of distributions and the required reporting to partners.

Analysis

The two examples in Treas. Reg. § 1.951A-1(e)(3) address partnerships with partners owning a fixed percentage of the partnership. However, in many cases, partners may have sharing percentages that differ from their capital percentage, and in fact may differ from the sharing percentage of a previous or subsequent period. In the case of a partnership that liquidates based on a distribution waterfall, the current year allocation of income may differ significantly from a partner's relative right to cash or distribution of other property.

The result of this difference is a potential shift in the allocation of the GILTI inclusion items away from partners who economically are entitled to the cash distributions from the CFC. If the general rule of Treas. Reg. § 1.958-1(c)(2), as applied in the context of subpart F income, is also applied to GILTI tested items, then generally, a partnership would look at how the share of income from the CFC is allocated in determining proportionate share of CFC stock. Applying the rules of section 951(a)(2), Treas. Reg. § 1.951-1(b), and Treas. Reg. § 1.951-1(e),¹² the allocation would look to the amount the U.S. shareholder would receive with respect to the stock of the corporation if, on the last day of the CFC's tax year, the CFC had distributed to its shareholders the amount of tested income.

In the case of a partnership that allocates income based on targeted capital accounts, a hypothetical distribution of the tested income from the CFC to the partnership, and then from the partnership to the partners, would: (1) increase overall section 704(b) income for the period (assuming the

¹² As modified by Treas. Reg. § 1.951A-1(d).

distribution were treated as a dividend); and (2) increase the amount of distribution to the partners, resulting in no net change to ending section 704(b) capital. However, because hypothetical liquidations are often tiered, an additional hypothetical distribution to certain partners would affect the overall sharing percentages for section 704(b) purposes.

Example

A U.S. partnership, PRS, has two partners: US1 (a U.S. individual) and F2 (a foreign individual). Prior to allocations of current year income, US1 has a section 704(b) capital account of \$40, and F2 has a section 704(b) capital account of \$60. The partnership agreement states that the first \$60 of cumulative distributions of capital are allocated to F2, the next \$60 of cumulative distributions are allocated to US1, and all remaining distributions are allocated 50% to US1 and 50% to F2. No distributions have been made to date. The partnership liquidates based on this distribution waterfall, and income is allocated to the partners to align their capital accounts with their economic rights under the waterfall.

The partnership has gross section 704(b) income before GILTI of \$30. Assuming no other contributions or distributions, income is then allocated \$25 (83.3%) to US1 and \$5 (16.7%) to F2, in order to align their ending capital accounts with their rights under the waterfall (\$65 of ending capital for both US1 and F2). However, the partnership also has \$50 of tested income. If this tested income was deemed distributed from the CFC to the partnership and from the partnership to the partners (and treated as dividend income), the partnership would have \$80 of section 704(b) income and \$50 of distributions. The distribution would first allocate 100% to F2 to satisfy the first tier of the waterfall. While total section 704(b) capital in the partnership is still \$130, it is now allocated \$90 to US1 and \$40 to F2 (to reflect the \$50 of capital distributed to F2). The income, therefore, is allocated \$50 (62.5%) to US1 and \$30 (\$37.5%) to F2.¹³

Under section 704(b) principles, all items of section 704(b) income should allocate based on these percentages. However, if both the GILTI items and taxable income items are allocated based on the hypothetical section 704(b) percentages of 62.5% and 37.5%, the true section 704(b) income items of the partnership will allocate inappropriately, and section 704(b) capital will not have alignment with hypothetical liquidation rights under the waterfall. Accordingly, it is not appropriate to allocate the GILTI attribute items as if they were distributed to the partnership on the last day of the tax year.

If the partnership were instead to allocate GILTI items to the partners in accordance with a hypothetical distribution of all the partnership's assets (rather than just of the tested income), each partner would share in the GILTI attribute items in accordance with how it would receive a distribution of the CFC's stock.

¹³ Note that if PRS was considered the U.S. shareholder for this purpose, the result would be the same. In this case, PRS's section 704(b) income would still be \$80, without a corresponding distribution to the partners. Accordingly, ending section 704(b) capital would be \$90 to US1 and \$90 to F2, and section 704(b) income would still be allocated \$50 to US1 and \$30 to F2.

In the example, the distribution of all the assets in PRS at fair market value (FMV) (excluding the tested income and assuming there is no section 704(b) to FMV differences) would result in a \$65 distribution to each partner. The addition of \$50 of FMV for the assumed increase in FMV of the CFC for the tested income would result in an additional distribution to each partner of \$25, and the GILTI attributes would allocate to the partners 50/50. This process ensures that the tested income is allocated in a manner that reflects the incremental distribution the partners will receive from the GILTI inclusion, rather than assuming the distribution of the cash from the CFC occurs at a specific point in the distribution waterfall that is dependent on the partnership's distribution policy or point in the partnership's life cycle.

Once the partnership determines how to allocate its GILTI attributes, the partner must determine its relevant GILTI inclusion, if any. Under section 961, the partner increases its basis in the partnership interest by the income recognized (though there is concern as to whether the partnership increases its basis in the CFC stock). The partnership, as the U.S. shareholder for reporting purposes, then must receive the information from the partner related to the GILTI inclusion in order to track the amount of PTEP that the partners have recognized.

As a result of the dichotomy between the partner being treated as the U.S. shareholder for purposes of GILTI inclusions and the partnership being treated as the U.S. shareholder for purposes of determining CFC status and reporting, additional ambiguity exists as to how the partnership should characterize a distribution in a future period from a CFC. There are two possible treatments to the partnership, depending on whether the partnership recognizes the PTEP from the U.S. shareholder partner in its calculation:

1. The partnership determines the character of the distribution as nontaxable to the extent of PTEP under section 959(a), and as a dividend (assuming appropriate levels of E&P) for the portion of the distribution in excess of PTEP.
2. The partnership determines the character of the distribution without regard to the U.S. shareholder's PTEP, treating the entire amount of the distribution without regard to any GILTI (and/or subpart F) inclusions at the partner level.

In the first scenario, the partnership is required to allocate its non-taxable income and its dividend income in accordance with section 704(b) principles. Therefore, it would allocate a portion of the non-taxable income and a portion of the dividend income to the U.S. shareholder partner and to other partners who have not previously had a GILTI inclusion. Accordingly, a portion of the PTEP distribution is shifted from the partner who previously recognized GILTI income to the partner that has not recognized GILTI, and the partner who previously recognized GILTI income would be subject to tax on the distribution of the related cash. This double taxation of the GILTI amount is inconsistent with section 959(a).

In the second scenario, the partnership would allocate dividend income to the U.S. shareholder partner who may have had a GILTI inclusion with respect to the GILTI items of the distributing CFC. In this case, section 959(a) should allow for the partner to exclude the dividend income associated with the CFC distribution from its gross income. However, the partnership would have

a requirement to disclose to the partner, in this case, the portion of the dividend income reported to it on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, relates to CFC distributions. In the case of partnerships with multiple CFCs, this reporting would occur on a CFC level for the partner to determine the appropriate PTEP exclusion from each CFC.

In either case, guidance is needed as to how the partnership can appropriately allocate items to partners in a manner that reflects each partner's historical recognition of GILTI related items.

C. GILTI Applied to S Corporations

Overview

Under section 1373(a), S corporations are treated as partnerships and their shareholders are treated as partners for purposes of subchapter N, part III, subpart A (foreign tax credit) and subpart F (controlled foreign corporations). Consequently, under Treas. Reg. § 1.951A-1(e)(1), for purposes of calculating GILTI inclusions under section 951A, S corporations should have treatment as foreign partnerships under section 958(a)(2). As such, CFC stock actually owned by an S corporation is considered as owned proportionately by its shareholders generally in accordance with their per-share, per-day allocation under section 1377(a)(1).

Under section 961 and Treas. Reg. § 1.961-1(a) and -2(a), GILTI inclusions increase or decrease the shareholders' stock bases in the S corporation. However, under the aggregate method adopted by the GILTI regulations,¹⁴ GILTI inclusions by S corporation shareholders are not items of income and deduction or loss that can increase or decrease the AAA under section 1368, because the AAA is an entity-level account and the GILTI inclusion effectively sidesteps the entity under the aggregate method. Distributions in excess of AAA generally are made from AE&P, if any, under section 1368(c). Income that does not increase AAA, therefore, does not provide a mechanism for tax-free distributions for S corporations with a balance of AE&P.

Recommendations

The AICPA recommends that Treasury and the IRS provide S corporations with guidance for addressing GILTI (and subpart F) as a result of the aggregate approach adopted under the final GILTI regulations.

The AICPA also recommends that Treasury and the IRS provide all S corporations with the option to continue to elect entity treatment, in a manner consistent with the proposed GILTI regulations, similar to the election provided for in Notice 2020-69 and without regard to AE&P or effective dates.¹⁵

¹⁴ See Treas. Reg. § 1.951A-1(e)(1) (domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a)).

¹⁵ Any S corporation could elect entity-level treatment, regardless of AE&P, subject to conditions herein (i.e. unanimous shareholder consent), described in 2. S corporation Electing Entity-Level Treatment, below.

Analysis

The proposed GILTI regulations¹⁶ adopted a hybrid approach for passthrough entities, in which some partners were treated as proportionately owning the stock owned by the domestic partnership for purposes of determining their own GILTI inclusion amounts, and other partners had a distributive amount of the GILTI inclusion calculated at the partnership level. This approach was rejected in the final GILTI regulations¹⁷ in favor of an aggregate method.

The final regulations focused primarily on the impact to partnerships. Partners receiving distributions from partnerships need only calculate whether they have enough basis in their partnership interest. With no AE&P present, partnerships lend themselves more easily to aggregate treatment. However, S corporations must calculate, at the entity level, whether distributions have exceeded AAA and are being made from AE&P before shareholders analyze whether distributions not made from AE&P have exceeded their basis. The analysis below details how our recommended approaches would apply a framework to reconcile the policy goal of GILTI while respecting the passthrough nature of subchapter S.

1. S Corporation not Electing Entity-Level Treatment (Default – Aggregate)

The AICPA is concerned regarding issues the IRS may face in administering the final GILTI regulations, as well as taxpayer compliance with the regulations, as they apply to S corporations and their shareholders. Further guidance is needed to address these concerns. Specifically, guidance is needed regarding the interaction of the aggregate approach for GILTI and the interaction of the stock basis rules (as they apply both to the S corporation's interest in the CFC and the shareholder's basis in the S corporation), the calculation of AAA, the character determination rule of section 1366, and the pro-rata per-share per day rule of section 1377. The recommendations proposed below are administrable and would harmonize the GILTI and Subchapter S regimes.

The following examples demonstrate concerns with the aggregate approach and some of the complexities that S corporations and their shareholders are facing in applying the current regulations:

Example 1 - Aggregate Method

A and B own 95% and 5% respectively of an S corporation. The S corporation owns 100% of a CFC generating GILTI tested items. A and B have no stock or debt basis, and the AAA balance is zero. The shareholder agreement provides that the S corporation will distribute cash to enable the shareholders to pay taxes on any taxable income, including GILTI income, based on the highest tax rate of the shareholders.

¹⁶ REG-104390-18.

¹⁷ [T.D. 9866](#).

The shareholders have no other tested income or loss. Tested income equals taxable income. CFC distributions will not qualify for the qualified dividend tax rate under section 1(h) and will receive the highest individual rate under section 1.

The shareholder subject to a tested income inclusion does not make a section 962 election. The shareholder increases its basis in the stock of the S corporation under section 961(a) for the amount of inclusion.

Earnings & profits of CFC	\$ 300,000
Foreign tax paid by CFC	<u>(30,000)</u>
Net tested income	270,000

Increase to AAA (none)	--0
GILTI reporting:	
Shareholder A – 95%	256,500
Shareholder B –5%	0
(B is not subject to GILTI)	

Shareholder A GILTI included in gross income	256,500
Tax on income @ 37%	94,905
(Net investment income tax disregarded)	

Increase to stock basis in S corp for shareholder A	256,500
Increase to stock basis in S corp for shareholder B	--0

Distribution based on tax on A:	
To A	94,905
To B (capital gain)	<u>4,995</u>
Total	\$ <u>99,900</u>

On the ultimate distribution of cash from the CFC to the S corporation, it is unclear whether the flow of cash from the CFC will trigger an inclusion of AAA for the full amount. The shareholder who included tested income in gross income will have received enough basis from the original inclusion to absorb its remaining distribution (\$256,500 less tax distribution of \$94,905). If we assume that it is not included in AAA, and that the S corporation functions as a mere conduit for the CFC to the ultimate shareholders, it appears that shareholder A merely reduces its stock basis for the distribution, while B first increases its basis in the S corporation for its entire share of CFC income and then reduces it by the distribution from the S corporation.

Cash from CFC	\$ 270,000
S corporation reduces distribution for prior cash distributed	<u>(99,900)</u>
Net cash distribution	<u>170,100</u>
Distribution to A	161,595
A's stock basis after distribution	---0

to successor stockholders, and whether distributions of property are allowed from PTI, should have consideration.¹⁹

2. S Corporation Electing Entity-Level Treatment

The hybrid approach allowed by [Notice 2019-46](#),²⁰ in which the S corporation was treated as the U.S. shareholder under section 958(a), provided needed simplicity. Under our recommended election (entity election), an S corporation electing entity treatment (as opposed to aggregate treatment) will have GILTI inclusions increasing AAA and stock basis. The S corporation may distribute from the AAA. This entity election would be available to all S corporations without restriction as to AE&P or effective dates. Under the entity election,²¹ all shareholders would include a pro-rata share of GILTI tested income and it would have treatment as an item of income. Stock basis would increase by the items of income, and shareholders would have a requirement to include these amounts in gross income, regardless of their ultimate percentage of ownership in the CFC. Under this entity election, eligible shareholders would have the ability to make a section 962 election on their personal tax return.

In order to facilitate tax administration, we recommend the following as part of making our recommended entity election:

- a) The election would require unanimous shareholder consent.
- b) The election would apply to all CFCs for which GILTI tested income was required to be reported to shareholders for the year.
- c) The election would be revocable only with the Commissioner's consent.

The following example demonstrates how an entity election to apply an entity approach would operate for purposes of applying GILTI for S corporations:

Example 2 - Entity Election to Apply Entity Approach

Same facts as *Example 1*, except S corporation elects entity treatment as a U.S. shareholder, and GILTI becomes an item of income at the corporate level that is passed through to the shareholders.

Tested income (before foreign tax)	\$ 300,000
Foreign tax paid by CFC	(30,000)
Increase to AAA	270,000
S basis in CFC stock increases by \$270,000	

¹⁹ This list is not exhaustive, and other situations may need consideration.

²⁰ This hybrid approach is also similar to the election provided for in Notice 2020-69, discussed in Part I, above. The hybrid approach is detailed in Prop. Reg. § 1.951A-5.

²¹ As noted above, this proposed election is similar to the election provided for in Notice 2020-69.

GILTI flow through on K-1:	
Shareholder A – 95% - increases stock basis	256,500
Shareholder B –5% - increases stock basis	13,500
Shareholder A GILTI included in gross income	256,500
Tax on income @ 37%	94,905
(Net investment income tax disregarded)	
Shareholder B allocation of (GILTI) income	13,500
Tax on income @ 37%	4,995
Total tax	<u>\$ 99,900</u>

The S corporation will distribute cash to the shareholders based on tax liability. The first distribution is \$99,900 as in Example 1 and the second distribution of \$170,100 is made once the CFC distributes cash to the S corporation. The distributions to A and B reduce AAA and stock basis.²²

Net cash to shareholders:	
To A	\$ 161,595
To B	<u>8,505</u>
Total	<u>\$ 170,100</u>

The shareholders are in the same position as in Example 1, except that shareholder B does not need to wait for a capital loss on disposition of its stock to be made whole.

Additional Consideration – S Corporation Section 962 Election

In many family-owned S corporations, shareholders holding less than 10% of the S corporation may constructively own enough of the CFC to be subject to GILTI.²³ This factor may affect tax compliance by introducing additional complexity on shareholder returns. Treasury and the IRS should consider allowing a section 962 election at the S corporation level. This election may provide needed simplicity for taxpayers and facilitate compliance.

Section 962 was enacted to give individual taxpayers who found themselves with an investment that unexpectedly generated subpart F income an alternative to including subpart F income at individual rates:

The purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign

²² See section 1368(b)(1) and (c)(1).

²³ This result occurs due to the section 958(b) attribution rules.

*earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.*²⁴

Section 962 provides that a U.S. shareholder, who is an individual, may elect to have the tax on amounts included in gross income under section 951(a) (subpart F income) as an amount equal to the tax imposed under section 11. In addition, section 962 provides that for purposes of applying section 960, relating to the foreign tax credit, the income is treated as if it were received by a domestic corporation.

When a U.S. shareholder receives a distribution from a CFC that is excluded from income under section 959(a), section 961(b)(1) provides that basis is reduced by the amount excluded from income. An individual making a section 962 election can claim the foreign tax credit on the income inclusion, but the individual must, under section 78, increase the income included by the amount of foreign tax paid. In general, Treas. Reg. § 1.961-2(a)(1) requires basis reduction upon a distribution from the CFC that is excluded from income under section 951(a). However, shareholders making a section 962 election reduce basis only by foreign taxes imposed.²⁵ Under Prop. Reg. § 1.962-1(b)(1)(i)(B)(3), a taxpayer making a section 962 election is permitted to take into account the section 250 deduction.²⁶

Section 962 provides that only U.S. shareholders who are individuals can elect corporate treatment. However, Treas. Reg. § 1.962-2(a) extends eligibility to trusts and estates. Thus, trust shareholders of S corporations should have the ability to elect section 962.

S corporations could create a domestic C corporation subsidiary and contribute the stock of the CFC to this entity. This method would eliminate the complexity of shareholder reporting and tracking but may not have feasibility in practice. This option – for the U.S. shareholder to incorporate a domestic corporation and contribute the CFC stock to this entity – has similarly always been available to individuals. However, Congress created the section 962 election precisely for individuals so as not to unnecessarily incur the extra burden and expense of corporate planning to accomplish the same goal.

Because S corporations calculate taxable income in the same manner as an individual under section 1363(b), a section 962 election for an S corporation would operate similar to that for an individual shareholder. The amount included in gross income would have treatment as if received by a C corporation, and it would face calculation under subchapter C. The foreign tax credit would be allowed under C corporation rules, and the section 250 deduction would also be allowed.

Importantly, such income is considered an item of income for AAA or stock basis purposes, since C corporation shareholders do not have their basis increased by subpart F or GILTI inclusions. U.S. tax paid by the S corporation would also not affect AAA or stock basis at the date of payment.

²⁴ S. Rep. No. 87-1881, at 92 (1962). Section 962 accomplishes this goal by taxing the electing individual first as a corporation for the Subpart F income, and secondly as an individual upon receipt of an actual distribution. Conceptually, if the U.S. individual had invested in a U.S. corporation earning income, the U.S. corporation would pay corporate level taxes, then make a dividend distribution of the income less taxes paid.

²⁵ Treas. Reg. § 1.961-2(a)(2).

²⁶ See REG-104464-18.

Instead, the S corporation would have, in effect, a “deemed C corporation subsidiary.” U.S. tax paid by the S corporation could be deemed as a capital contribution to the deemed subsidiary and could increase the S corporation’s basis in the deemed subsidiary. Alternatively, it could have treatment as an intercompany loan to the deemed subsidiary.

Upon an eventual distribution from the CFC, the deemed subsidiary is considered to receive the distribution. Similar to an actual C corporation subsidiary, the distribution from the deemed subsidiary to the S corporation is then treated as a distribution. If the distribution is a dividend, it is necessary to characterize it with reference to the CFC’s treaty status. Thus, the dividend from a deemed subsidiary is ordinary if the CFC distribution itself did not qualify for qualified dividend treatment under section 1(h).

The dividend is an item of income and would increase AAA and stock basis. It would pass through to the shareholders under section 1366.

Example 3 – Section 962 Election at Entity Level

Same facts as *Example 1*, except S corporation elects to apply GILTI at the entity level as well as electing section 962 at the entity level.

Tested income (before foreign tax)	\$ 300,000
Foreign tax paid by CFC	<u>(30,000)</u>
Tested income	270,000
Gross-up under section 78	<u>+ 30,000</u>
After Gross-up	300,000
Section 250 Deduction	<u>(150,000)</u>
Net taxable income to S corporation	\$ <u>150,000</u>
Corporate tax at 21%	\$ 31,500
Foreign tax \$30,000 x 80% limit = foreign tax credit	<u>24,000</u>
Net U.S. tax on income (paid by S corp)	\$ <u>7,500</u>
Increase to AAA	--0
Increase to stock basis of S corporation shareholders	--0
Increase to AE&P	--0
Increase to basis in deemed subsidiary	7,500
Increase to PTEP of deemed subsidiary	7,500
Ultimate distribution:	
Distribution of cash from CFC to deemed subsidiary	\$ 270,000
Distribution of cash from deemed subsidiary to S corporation	270,000
Return of basis / repayment of loan	(7,500)

Taxable dividend to report on Schedules K-1 \$ 262,500

Dividend is ordinary or qualified depending on the status of the CFC

Cash to A	\$ 249,375
Cash to B	\$ 13,125
If taxed at 37% to shareholders:	
A's taxes	\$ 92,269
B's taxes	4,856
Net cash to A	\$ 157,106
Net cash to B	<u>8,269</u>
Total net cash to shareholders	<u>\$ 165,375</u>

The effect on A is the same as if the aggregate method is followed and A makes a section 962 election (absent other CFC GILTI tested income and losses includible by A). The effect on B, the non-U.S. shareholder of the CFC, is to reduce its cash initially. However, it will not need to wait until redemption of its stock to be made whole, as in Example 1. Neither shareholder would require tracking PTEP or including GILTI calculations on its tax return, which would facilitate compliance. The S corporation would not make distributions in the year of the GILTI tested income because no income is passed through to the shareholders, and therefore no question of distributions exceeding AAA or basis arise.

Allowing entity-level election taxation of GILTI and permitting S corporation to make a section 962 election would allow S corporations and their shareholders the same results they can already achieve by having the S corporation contribute its CFCs into a new C corporation. However, as the process of transferring stock of foreign corporations is difficult and costly, allowing for the election would greatly reduce the costs and complexities associated with the current regulations. Allowing for the election would minimize the difficulties and costs that S corporations must undertake in order to structure their operations to achieve the same results. These recommendations also align with both the spirit and intent of respecting Subchapter S.