Journal of Korean Law | Vol. 22, 1-41, February 2023

# Internal Revenue Code Section 962 Election and Its Cross-Border Tax Compliance Implications*

*Joung Keun Cho***

## Abstract

*§ 962 "Election by Individuals to be subject to Tax at Corporate Rates" of the Internal Revenue Code ("IRC" or "Code") of the United States ("U.S.") was treated as an "'obscure little backwater' area of the law" until the enactment of the Tax Cuts and Jobs Act of 2017 ("TCJA") reduced the corporate tax rate to 21 percent. As the Global Intangible Low-Taxed Income ("GILTI") affects the individual U.S. taxpayers who are shareholders in foreign corporations do not get the participation exemption, this § 962 has become very important. From the basic idea of humans being taxed as if they were corporations for some specific purposes, the § 962 election toggles a different tax result under four different IRC sections; it creates less inclusion in gross income, namely § 250 Foreign-Derived Intangible Income ("FDII") and GILTI, which creates a lower tax rate by invoking the corporate income tax rate under § 11 "Tax Imposed" rather than the human tax rate under § 1 "Tax Imposed". It also allows human beings to take the indirect foreign tax credit permitted by § 960 "Deemed-Paid Credit for Subpart F Inclusions". Finally, § 962 obliterates the entirely fabulous § 959 "Exclusion from Gross Income of Previously Taxed Earnings and Profits" in which all dividends from controlled foreign corporations ("CFCs") are tax-free, and instead substitutes a new rule stipulating that some of the dividends are going to be taxable indeed. From this perspective, an individual U.S. shareholder of a Korean corporate entity can take advantage of § 962 election as her tax can be calculated using the corporate tax rate of 21 percent and applicable*

* The author thanks the anonymous reviewers for their careful reading of the manuscript and their many insightful comments and suggestions. The author also thanks to founding partners of Estate & Trusts Advisors LLP; Ms. Yang Soo Kim, Mr. Hyun Chan Jung, KICPA, and Mr. Terry Kim, AICPA, for their discussion and support for the development of the estate planning solutions for the Korean private clients throughout the weekly Internal Dialogue. A special thanks to Mr. Seon Goo Lee, C.E.O. of ArtiWealth, Ms. Ji-Yeon Kim, and Koonghee Nam, Directors of N.H. Investments and Securities (Premier Blue) for their heartful supports and open exchanges. Some part of the elaboration is based upon various insightful inputs from these gentlemen, but any error remains solely responsible to the author of this article. This Research was supported by Seokyeong University in 2023.

** Associate Professor of Finance and Int'l Taxation Law, Seokyeong University School of Business.

*deemed-paid foreign tax credits but always with the caveat of additional tax payable in future when actual dividends are paid. This adds complexity but can be a significant timing benefit in the right circumstances since there is a cash-flow advantage from delaying an actual tax payment to an indefinite future year. This article covers what problems the election solves and how it solves them and provides a specific overview of § 962 from the perspective of U.S. shareholders in Korean corporations.*

KEYWORDS: § 962 election, subpart F income, GILTI, foreign tax credit

*Manuscript received: August, 29, 2022; review completed: December 28, 2022; accepted: February 20, 2023.*

## I. Introduction

A U.S. taxpayer who is subject to income tax in both the U.S. and Korea may reduce the amount of tax payable to the U.S. by claiming a credit for foreign income taxes paid or accrued to Korea. The principle is as simple as that the taxpayer should not pay tax twice with respect to the same item of income. However, in its real-world application, the principle is not that simple, requiring a taxpayer to overcome several hurdles including whether the tax is indeed creditable. The Code provides a credit for two broad classes of tax: § 901 "Taxes of Foreign Countries and of Possessions of U.S." allows a credit for foreign taxes levied on "income, war profits, or excess profits," which is the requirement of the foreign tax being an "income tax." At the same time, § 903 "Credit for Taxes in lieu of Income, etc., Taxes" allows a credit for foreign taxes levied "in-lieu-of" a tax on items such as a gross income tax imposed on non-residents in connection with non-trade or non-business income within the country, where residents with a trade or business are generally taxed on realized net income. The working mechanism might be referred from the following example[1]:

1) Treas. Reg. § 1.701-2 "Anti-Abuse Rule, Example 3. Choice of Entity; Avoidance of more restrictive foreign tax credit limitation; Use of partnership consistent with the intent of subchapter K.".

> (i) X, a domestic corporation, and Y, a foreign corporation, form the partnership PRS under the laws of foreign Country A to conduct a bona fide joint business. X and Y each own a 50 percent interest in PRS. PRS is properly classified as a partnership under Treasury Regulations § 301.7701-2 and 301.7701-3. PRS pays income taxes to Country A. X and Y chose the partnership form to enable X to qualify for a direct foreign tax credit under § 901, with look-through treatment under Treasury Regulations § 1.904-5(h)(1). Conversely, if PRS were a foreign corporation for U.S. tax purposes, X would be entitled only to indirect foreign tax credits under § 902 with respect to dividend distributions from PRS. The look-through rules, however, would not apply, and pursuant to § 904(d)(1)(E) and Treasury Regulations § 1.904-4(g), the dividends and associated taxes would be subject to a separate foreign tax credit limitation for dividends from PRS, a non-controlled[2] § 902 corporation.
>
> (ii) Subchapter K is intended to permit taxpayers to conduct a joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS in order to take advantage of the look-through rules for foreign tax credit purposes, thereby maximizing X's use of its proper share of foreign taxes paid by PRS, is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1), (2), and (3) of this section have been satisfied. The Commissioner, therefore, cannot invoke paragraph (b) of this section to recast the transaction.

Applying Example 3 of Treasury Regulations § 1.701-2(d) to our discussion, X is a U.S. corporation owning 50 percent of PRS, a Korean

---

2) In addition to the meaning of "control" under Treas. Reg. § 1.6038-2(b) "A person shall be deemed to be in control of a foreign corporation if at any time during that person's taxable year it owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or more than 50 percent of the total value of shares of all classes of stock of the foreign corporation" it also apply the standard constructive ownership rules of § 318(a)(3) that if 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

entity. The other 50 percent of PRS is owned by Y, a Korean corporation. The example states that PRS is classified as a partnership for U.S. tax purposes under entity classification regulations. Note that it is often necessary to make an affirmative entity classification election, also known as a check-the-box election by Form 8832 "Treaty-Based Return Position Disclosure" under § 6114 or 7701(b) to treat foreign entities as partnerships. Under Treasury Regulations § 301.7701-3(b)(2), the default classification rule for foreign eligible entities, if all the owners of a foreign entity have limited liability, the entity defaults to be treated as a corporation for U.S. tax purposes.[3)]

Now, back to Example 3: PRS is taxed as a partnership, meaning that there may have been an entity classification election made for PRS. With PRS taxed as a partnership, Korean corporate income taxes paid by PRS flow up to the U.S. parent so that Corporate X can claim foreign tax credits under § 901. If PRS were taxed as a corporation, Corporate X would only be able to claim deemed paid foreign tax credits under § 902 when PRS pays dividends to Corporate X. This type of entity classification election is often more important for individuals owning interests in foreign entities because individuals cannot qualify for deemed foreign tax credits under § 902 (were PRS classified as a corporation). If Corporate X were instead human X who is a U.S. person, the decision to treat PRS as a partnership vs. as a C corporation results in human X being able to claim foreign tax credits paid by PRS for not being able to claim foreign tax credits for income taxes paid by PRS. If PRS is classified as a partnership, U.S. individual X can claim foreign tax credits paid by PRS. In case PRS is classified as a C corporation instead, individual X cannot claim foreign tax credits paid by PRS.

Cho[4)] suggested the potential utility of offshore tax blockers[5)] in

---

3) Note the default classification rule for foreign entities is not the same as the default classification rule for U.S. entities. U.S. limited liability companies with more than one owner default to be classified as partnerships with no need to make an entity classification election. Unfortunately, some tax advisors who are not familiar with these rules believe that any foreign limited liability company will default a partnership classification when in fact it defaults to be classified as a corporation.

4) Joung Keun Cho, *Cross-border Tax Implications in the U.S. CLO Equity Investing by the Qualified Korean Investors*, 6(2) Asset Mgmt. Rev. 1, 17 (2018).

5) Tax blockers are the U.S. or foreign entities that are classified as corporations for U.S.

outbound investment structuring of U.S. collateralized loan obligations by qualified Korean institutional investors to facilitate two different characteristics of income cash flows from the underlying loan origination activities, which are effectively connected income from U.S. trade or business and the original returns from holding risk-retention notes, which are portfolio interests. Cho[6] also suggested trust-tiered pass-through models of outbound investment structuring in U.S. real properties by Korean individual investors and investigated the relevant cross-border tax compliance issues. By shifting gears, this paper explores the *pros* and *cons* of IRC § 962 election in outbound structuring from the U.S. individual taxpayer's perspective to accommodate the assured level of tax compliance in both jurisdictions as well as the coordination with the foreign tax credit regime in Korea.

The article proceeds as follows. Section 2 discusses § 962 election by individual taxpayers to be eligible for corporate rates. Section 3 discusses the deduction frameworks of both § 250 FDII and § 951A(a) GILTI regimes. Section 4 formulates a set of § 960 deemed-paid foreign tax credit rules. After the caveats on taxable dividends from net investment income tax purposes in Section 5, Section 6 considers the rules of deemed dividends of a specific foreign company and foreign tax credits in Korea followed by a discussion regarding potential combined elections and subsequent domestic hybrid mismatch issues in Section 8. Internal Revenue Service (hereinafter "IRS") Revenue Ruling 88-25 as an alternative consideration to § 962 election in Section 8. Section 9 concludes.

---

income tax purposes. Offshore blockers may check-the-box under Treas. Reg. § 301.7701-3 to elect their classification for federal tax purposes, or they may be classified as corporations under the default rules. The blocker structure eliminates both the risk of filing a U.S. tax return and the risk that a foreign investor may be deemed to be engaged in a U.S. trade or business by blocking potential U.S.-source effectively connected income and the character of income at the blocker level.

6) Joung Keun Cho, *An Investment Structuring of U.S. Real Properties by Korean Families and Cross-border Tax Implications*, 21(1) J. Korean. L. 55, 90 (2022).

## II. § 962 Election by Individuals to be Subject to Tax at Corporate Rates

This discussion is to start way back before putting § 962 election[7] in context: U.S. citizens and permanent residents (hereinafter "U.S. individual tax residents") residing in Korea and running a generic brick-and-mortar kind of business, which could be anything from a manufacturing plant to a franchisee business of fried chicken run through a corporation like every other local business. For our purposes, the U.S. individual tax resident is 100 percent owner of a Korean corporation's real operating business. The same principles are going to apply as if a U.S. tax resident living in the U.S., until coming down to the direct foreign tax credit at the very end for dividend payments. Since our U.S. taxpayer is living in Korea, the person is not going to pay full tax on dividends received, as there will be withholding at source in all probability but there won't be as much.

Subchapter C of the IRC applies to all corporations, foreign or domestic unless the Code says otherwise. Subchapter C says that shareholders do not recognize income until the corporation makes a distribution to them or they sell stock under § 301 "Distributions of Property." § 951A creates an exception[8] to that core principle of Subchapter C: Some U.S. shareholders must pay U.S. income tax on some of a foreign corporation's GILTI – whether or not the foreign corporation makes a distribution to the U.S. shareholders. § 951A(a) provides each person who is a U.S. shareholder of any CFC for any taxable year of such U.S. shareholder shall include in the

---

7) If a taxpayer makes the § 962 election, § 962(a)(1) provides "the tax imposed under this chapter on amounts which are included in her gross income under § 951(a) shall (in lieu of the tax determined under § 1 and § 55) be an amount equal to the tax which would be imposed under § 11 if such amounts were received by a domestic corporation[.]".

8) § 951A can be summarized as a subtraction game: From CFC's Gross Income, Form 5471, Schedule I-1 on Line 1 minus Gross Income Exclusion on Lines 2, 3 equals Gross Income Minus Exclusion (or "Gross Tested Income") on Line 4. Then the Tested Income on Line 6 comes after subtracting CFC's Expenses & Taxes Allocable to Gross Tested Income on Line 5. GILTI at Form 8992, Part II on Line 5 comes after the deduction of Net Deemed Tangible Investment Return, Form 8992, Part II on Line 4. This GILTI goes to shareholder's Gross Income either on Form 1120, Schedule C on Line 17 for a corporate shareholder or on Form 1040, Schedule 1, Part I on Line 8 for an individual shareholder.

gross income of such U.S. shareholder's GILTI for such taxable year.

Under § 957(a) "CFCs; U.S. Persons," the CFC means any foreign corporation[9] if more than 50 percent of: (1) the total combined voting power of all classes of stock of such corporation is entitled to vote, or (2) the total value of the stock of such corporation is owned within the meaning of § 958(a) "Rules for Determining Stock Ownership by U.S. Shareholders" or is considered as owned by applying § 958(b) "Stock Ownership through Foreign Entities" on any day during the taxable year of such foreign corporation. Furthermore, § 951(b) "Amounts included in Gross Income of U.S. shareholders" defines the U.S. shareholder (as modified by Rev. Proc. 2019-40) with respect to any foreign corporation as a

> U.S. person (as defined in § 957(c)) who owns within the meaning of § 958(a) or is considered as owning by applying the rules of ownership of § 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of such foreign corporation.[10]

If § 962 election is so fabulous and is going to cure every probable "human tax-related disease," then what exactly is the human tax-related disease? The origin of the disease comes from the principle that the U.S. has citizenship-based taxation, which means, unlike every other civilized country, if the U.S. citizen leaves the U.S., the taxpayer is still liable to U.S. tax no matter what. If a U.S. tax-resident-owned Korean corporation turns profitable and makes a net profit at the end of the year, it is subject to corporate income tax in Korea. Because of the rules of either Subpart F Income under § 951(a) or GILTI under § 951A, the U.S. shareholder is going

9) § 7701(a)(5) provides "Foreign" corporation or partnership means not domestic. § 7701(a)(4) provides "Domestic" corporation or partnership means created or organized in the U.S. or under the law of the U.S. or of any State unless, in the case of partnership, the Secretary provides otherwise regulations. § 7701(a)(9) provides "U.S." includes only the State and the D.C., while § 7701(a)(10), "State" shall be construed to include the D.C.

10) The standard definition is at § 7701(a)(30): § 7701(a)(3)(A) for U.S. citizen and resident alien, § 7701(a)(3)(B) for U.S. partnership, § 7701(a)(3)(C) for U.S. corporation, § 7701(a)(3)(D) for U.S. estate, and § 7701(a)(3)(E) for U.S. trust.

to have imputed gross income added into his, her, or its adjusted gross income and be subject to U.S. individual income tax on that. The big problem here is that the U.S. shareholder[11] has got double taxation on the same blob of net profits: first at the corporate level in Korea and second at the individual level in the U.S. And there is no ability to take the foreign tax credit just by default by the individual. The normal treatment of the U.S. shareholders of a CFC is 100 percent taxable income inclusion of § 951(a) Subpart F income and § 951A GILTI. While up to 37 percent of the federal personal income tax rate is applicable, no indirect foreign tax credit is available to this U.S. tax resident. Furthermore, any dividend received is not subject to income tax but still subject to a net investment income tax (hereinafter "NIIT") of 3.8 percent.

The § 962 election changes four things: It creates less inclusion in the gross income of a GILTI category since the tax rate to be included in the individual's gross income is going to be 21 percent, and the election will allow taking the indirect foreign tax credit under § 960 "Deemed Paid Credit for Subpart F Inclusions." Ordinarily, this is reserved only for corporations, but individuals are allowed to claim the indirect foreign tax credit if they make the § 962 election. Therefore, this U.S. shareholder can pretend that he, she, or it actually paid the corporate income tax that the Korean corporation, in real life, paid. In the default mechanism, previously taxed earnings and profits are not taxed at all, but, within the § 962 election context, dividends are taxed according to a messy little formula.

This all came into being in 1962 (in the Stone Age), and what the U.S. Congress was trying to do when they first introduced the Subpart F rule was to give a situation where an individual shareholder would be indifferent as to whether he or she is operating a foreign business through a foreign corporation or operating a foreign business through a branch

---

11) A Korean corporation is a CFC for U.S. tax purposes if it is more than 50 percent owned by U.S. shareholders. A U.S. person is a U.S. shareholder with respect to a CFC if such U.S. person owns at least 10 percent of the CFC's stock. In both cases, ownership is determined by vote or value. If a Korean corporation is a CFC, U.S. shareholders of the CFC who own shares directly or indirectly through Korean entities on the last day of the CFC's taxable year are taxed currently on certain CFC's earnings, regardless of whether such earnings are distributed. These taxes result from either the Subpart F regime of 1962 or the GILTI regime of the TCJA of 2017.

operation of a U.S. domestic corporation. If a Delaware C corporation is chosen as a default case, income inclusion of Subpart F including passive income such as dividends would drop onto Form 1120, "U.S. Corporation Income Tax Return," as income. Fifty percent of § 951A income would be included under § 250 based on FDII when a domestic corporation has foreign income, which is entitled to a 50 percent deduction. This C corporation is allowed to take an indirect foreign tax credit for any taxes paid in a foreign jurisdiction on the branch operations. The U.S. shareholder would indeed pay income tax on dividends if the dividends were distributed from the C corporation to the shareholder, which was a rough template of what the U.S. Congress was trying to do. But as usual in the IRC, contrary to their initial direct foreign corporate vs. domestic branch equivalence taxation planning for the benefit of U.S. tax residents, when the pieces are bolted together, sometimes they don't bolt together all that well. Taxpayers must deal with a few mismatches now and then, but it has worked approximately correctly.

## III. § 250 FDII and § 951A(a) GILTI Regimes

Both § 951(a) and § 951A force the inclusion of the CFC's corporate net income into the gross of U.S. shareholders. Even with a 100 percent push-up, a deduction can be created because of § 250. So, who can make the § 250 deductions? While § 250(a) provides eligibility for any U.S. C corporation only, Treasury Regulations § 1.962-1(b)(1)(i)(B)(3) also opens for those individuals who make the § 962 election the option to have Subpart F income and § 951A income taxed using C corporation tax methods. Furthermore, § 250(a)(1)(B) reads, "In the case, if a domestic corporation for any taxable year, there shall be allowed as a deduction an amount equal to the 50 percent of the GILTI amount (if any) which is included in the gross income of such domestic corporation under § 951A for such taxable year." There is a companion kind of § 250 deduction called FDII, which is for U.S. corporations doing business abroad where the taxpayer can functionally get the same 50 percent deduction that is in favor of the taxpayer.

For § 951(a) Subpart F income, the starting point is Schedule I for the CFC of IRS Form 5471, "Information Return of U.S. Persons with respect to

Certain Foreign Corporations." The inclusion runs over to Schedule 1 attached to Form 1040, "U.S. Individual Income Tax Return," which bubbles over to the front page of Form 1040 in gross income. It works its way down by subtracting anything like the standard deduction to come to the tax resident's annual taxable income. After computing the tax, the taxpayer ends up with the income tax liability on Line 12a of Form 1040, which means Subpart F income gets taxed as ordinary income. For § 951A GILTI, it is a little more complicated, but the same idea holds true, as 100 percent of income flows through and gets taxed at the ordinary rates, i.e., 100 percent of the income from Form 5471, Schedule I-1 will flow through Form 8992, "U.S. Shareholder Calculation of GILTI," because this is where the computation of the inclusion amount happens, and then on to the tax return through Schedule 1 and page 1 of Form 1040 and then, eventually, to the tax liability.

This is how taxable income is reduced by 50 percent: With the § 962 election, an ability to take the § 250 deductions can be introduced. Again, the starting point is the income inclusion amounts on Schedule I-1 of Form 5471 and then the transition to Form 8992. By computing the inclusion amount and after a little detour onto Form 8993, § 250 basically takes the total inclusion amount multiplied by 50 percent to end up with the deduction amount. Therefore, a § 962 tax return for an individual requires taking 100 percent of the income from Form 8992 and 50 percent of the income as a deduction on Form 8993 by porting both these amounts over to some extra math to take the bottom-line tax liability and drop it on to Form 1040.

§ 962(a)(1) provides "the tax imposed under this chapter on amounts which are included in her gross income under § 951(a) shall (in lieu of the tax determined under § 1 and § 55[12]) be an amount equal to the tax which would be imposed under § 11 if such amounts were received by a domestic corporation." When the taxpayer makes the § 962 election, the taxpayer does not have to pay tax on this gross income exclusion at ordinary rates of up to 37 percent, instead applying corporate rates of 21 percent. Just pretend that the amounts included under § 951(a) Subpart F income will be

12) I.R.C § 55, "Alternative Minimum Tax Imposed".

**Exhibit 1.** Combined Effect of Less Taxable Income and Lower Tax Rate

| | No § 962 Election | With § 962 Election |
|---|---|---|
| § 951A Gross Income Inclusion | $1,000,000 | $1,000,000 |
| § 250 Deduction | n/a | ($500,000) |
| Net § 951A Income Inclusion | $1,000,000 | $500,000 |
| Less: Standard Deduction | ($12,950) | n/a |
| Taxable Income | $987,050 | n/a |
| Applicable Tax Rate (assumed) | Average 30% | 21% |
| Income Tax Liability | $296,115 | $105,000 |
| Tax Liability Reduction | n/a | $191,115 |
| Net Income After Tax | $703,885 | $895,000 |

equal to the amount that would be imposed under § 11. Additionally, § 951A(f) provides treating the GILTI pass-through in the same manner therefore the § 11 rule applies as well. While § 11 provides an arbitrary change in the tax rate, § 250 provides an arbitrary change in the amount of taxable income. Let us look at the two of them together and see what the impact will be in Exhibit 1.

Let us assume that a U.S. citizen living in Korea running his own business through a corporation like every other business in Korea. Exhibit 1 shows a sample tax return, if, without § 962 election, just the default methodology applies. § 951A gross income inclusion is assumed to be $1,000,000, which means this is the amount that drops onto Form 1040, and the standard deduction is arbitrarily assumed for the taxpayer in the tax year 2022, to be filed in 2023. Then, the taxable income is $987,050. With an average tax rate of 30 percent, the total tax liability is $296,115. The far right-hand column shows the effect of the § 962 election: In pretending to be a corporation, there is no standard deduction applicable. However, under the first impact of § 250, deductions of $500,000, and the subsequent impact of corporate tax rate application under § 11, the total tax liability drops to $105,000, which is a $191,115 savings in income tax liability on this GILTI inclusion just by making the § 962 election.

## IV. § 960 Deemed-Paid Foreign Tax Credit Rules

A harder question might be whether our individual U.S. tax resident, who is at the same time a U.S. shareholder, is allowed to have a foreign tax credit to go with the income inclusions. The baseline rule of § 960 allows the indirect foreign tax credit, but it is reserved only for corporations. The foreign tax credit rules under § 901(b)(1) provide that any individual taxpayer is allowed to take a foreign tax credit for taxes actually paid by him or her, a.k.a. a direct foreign tax credit, or any taxes deemed paid by him or her, because of § 960. Without the § 962 election, he or she can't take either because the Korean corporation paid a Korean tax, not the U.S. shareholder at the top. Therefore, there is no direct foreign tax credit available because of § 901.

Then, what about the indirect foreign tax credit? § 901(a) "Allowance of Credit on Taxes of Foreign Countries and of Possessions of U.S." and § 960 "Deemed Paid Credit for Subpart F Inclusions" provide that only domestic corporations (not individuals) can take an indirect foreign tax credit for foreign income tax paid by their subsidiaries. That is two strikes already under the shadow of double taxation. However, § 962(a)(2) provides that individuals who elect § 962 treatment may use the § 960 indirect foreign tax credit. Therefore, § 962 allows individual taxpayers to use the indirect foreign tax credit rules otherwise reserved for corporations.

The next question is how much tax credit can be taken under the influence of § 962 election? From the basic concept of the foreign tax credit, there is a limitation elaborated in § 904 "Limitation on Credit," which haircuts the amount of actual tax paid on that income item and says the most foreign tax credit the taxpayer can take is either what the individual has paid on that income for U.S. tax purposes or what the individual has paid in real life to the foreign government, and the taxpayer can never take more than the amount that he, she, or it paid to the U.S. on that same income.

For GILTI, there are two limitations on how much tax credit the individual taxpayer can claim. This is all baked into Form 1118 "Foreign Tax Credit—Corporations."[13] In real life, the CFC pays 100 percent of the tax, and § 960(d) allows taking an 80 percent deemed paid tax credit, just

for GILTI: The taxpayer would take a 20 percent haircut off the top and be allowed to take that § 960(d) limited amount. Then, under § 904, the taxpayer would compare the amount deemed paid to the foreign government against the actual tax liability in the U.S. and end up with the allowable U.S. tax credit. By contrast, there are no special protocols built into § 960(d) for Subpart F income such that the taxpayer's maximum credit allowed is the tax liability computed for U.S. tax purposes. Then the sequence is obviously more important for GILTI.

We have discussed in a general sense how the taxpayer can take the foreign tax credit for corporate income paid by the CFC, but the taxpayer can take that credit on the individual income tax return. In order to do this correctly and let the math work out properly, there is a gross-up amount. Back to Exhibit 1, there was going to be $1,000,000 of income at the corporate level and the Korean corporation was going to pay $250,000 in tax, and the earnings and profits within the corporation after payment of the Korean corporate income tax were $750,000. If the taxpayer would pass-through that $750,000 as GILTI, which is the way Form 8992 would handle the math, then the individual U.S. shareholder would get the best of both possible worlds, namely, the reduced taxable income and the foreign tax credit. Since it is a principle to prohibit providing the taxpayer a deduction and a credit at the same time, the U.S. shareholder's gross income inclusion is increased by the amount of income tax actually paid by the Korean corporation under § 78,[14)] which provides for whatever tax was paid by the Korean corporation and treats that as a deemed dividend to the shareholder and, that way, the taxpayer would gross up the income to the correct amount to take the foreign tax credit.[15)]

---

13) From IRS Pub. 514, *Foreign Tax Credit for Individuals* 6 (2019) ("If you are a shareholder of a controlled foreign corporation and choose to be taxed at corporate rates on the amount you must include in gross income from that corporation, you can claim the credit based on your share of foreign taxes paid or accrued by the controlled foreign corporation. If you make this election, you must claim the credit by filing Form 1118. See IRC §§ 960 and 962 for more information."). Therefore, the § 904 limitation amount is calculated at the Form 1118 Part III, Line 1 Schedule B and the amount goes to Schedule 3 of Form 1040.

14) For dividend under § 78 "Gross up for Deemed Paid Foreign Tax Credit", from Part II, Column 4 of the Form 1118, $200,000 would kick in as the 80 percent limitation of $250,000 taxes paid, which is going to be the deemed limited number under § 960(d) and then is going to be the § 904 limitations on the allowable foreign tax credit.

**Exhibit 2.** Key Benefit of Section 962 Election

| Item | Amount |
|---|---|
| Korean Corporate Income Tax Paid on § 951A Income | $250,000 |
| U.S. Shareholder's Personal Income Tax Liability on § 951A Income Inclusion | $105,000 |
| § 960 Foreign Tax Credit* | ($105,000) |
| Net Worldwide Tax Cost (the Korean CFC and the U.S. shareholder) | $250,000 |

* § 960 Foreign Tax Credit = Min ($200,000, i.e., 80% of Actual Taxes Paid, $105,000, i.e., U.S. Tax Liability)

Exhibit 2 is a summary of a high-level result showing how double taxation is eliminated because the taxpayer is allowed to take indirect foreign tax credits. Starting with this CFC's $1,000,000 net income, $250,000 of Korean corporate income taxes were paid, and the income was sent through to the individual taxpayer by using the § 11 calculations to reduce income by half and then applying a 21 percent federal corporate tax rate, which results in $105,000 because that is 21 percent of $500,000 of taxable income. Because of the § 904 limitations, the taxpayer gets the lower of the U.S. tax liability of $105,000 or 80 percent of the actual tax paid, which is $200,000. The § 951A income exclusion and the tax liability on that would be exactly set off by the allowed foreign tax credit, which means the only tax imposed on this Korean corporation's net profits will be the Korean corporate income tax paid in Korea as God intended. This is the critical element that the taxpayer is shooting for when they make the § 962 election. This can make all the difference in the world to the effective tax rate worldwide for a U.S. shareholder in a CFC. From Exhibit 2, because any tax liability up to $200,000 would have been completely offset by the indirect foreign tax credit, it really doesn't matter whether the applicable tax rate is 21 percent or 25 percent at the corporate level.

15) In a very simplistic way, by adopting Form 1118 to calculate the results at the corporate level for the CFC, the foreign tax credit amount would be dropped on to Form 1040 Schedule 3, which is the taxpayer's final tax credit on Line 13b. But the § 78 dividend is going to go into the Schedule C and adds back into the corporate income to end up the true tax

## V. Taxable Dividends in Net Investment Income Tax Purposes

Dividends are one of the things that the § 962 election would change, i.e., the election creates dividend income for a CFC's individual shareholders where none previously existed. Therefore, unlike the previous discussions where the changes resulting from the election were in favor of the taxpayer's wallet, this one works the other way around. Then, how much is included in gross income (now a taxable dividend income), and how much is excludable? A short summary of this: Even though there is a computed tax liability in Subpart F and/or GILTI concerning certain income inclusion, it does not automatically create the same dollar amount as an excludable non-taxable dividend from the CFC to the U.S. shareholder. As soon as any foreign tax credit would offset that dollar amount, this is going to reduce the excludable distribution amount all the way down to zero if that were how much foreign tax credit the taxpayer would get.

Here is the basic idea of § 962 election and its impact on dividends for the CFC: § 959 "Exclusion from Gross Income of Previously Taxed Earnings and Profits" is the default rule providing that when a U.S. shareholder receives a distribution of previously taxed earnings and profits, that distribution is not included in gross income. Since the individual taxpayer already paid the income tax according to its Subpart F or GILTI inclusion, the taxpayer would not pay a second tax when cash is distributed out from the corporation to the shareholder, which is good since no one likes two levels of tax. Unfortunately, § 962(d) "Special Rule for Actual Distributions" throws that rule overboard and substitutes something else that provides that some of that distribution the shareholder is receiving will indeed be dividend income to them and they will have to pay tax, and the taxpayer is

---

liability on Line 12a under § 962. In more detail, from Schedule C attached to a Form 1120 on Line 17, starting with $1,000,000 of income, paid $250,000 of tax, which means that Form 8992 gave $750,000 of GILTI with $250,000 of tax in Line 18 shows where the taxpayer would gross-up income again and then drop down to Line 23, the total for that column. There is total income of $1,000,000 again and just referencing back to the § 250,000 deduction works in real life by reducing taxable income for computed under corporate theory from $1,000,000 to $500,000 since the taxpayer takes that Line 24 and ports it over the page 1 of the Form 1120.

back in the double taxation zone. And this is not surprising, since the original plan in the U.S. Congress back in 1962 was to create a rule that says an individual U.S. shareholder should be in approximately the equivalent position operating a foreign business through a foreign corporation or operating a foreign business as a branch of a domestic corporation. And if the individual taxpayer had a domestic corporation, when dividends come out of his or her favorite Delaware C corporation, the shareholder is going to pay tax. Therefore, though not unexpected, not pleasant, it is working as exactly desired by the U.S. Congress.

The distributions are taxable dividends and subject to 3.8 percent NIIT, which is a separate tax and unaffected by § 962(d). The definition of "Net Investment Income" for NIIT purposes is different from the definition of "Gross Income" for income tax purposes. The taxable portion and the excludable portion are both distributions of earnings and profits and are therefore dividend income. Net investment income includes dividend income, which makes the entire distribution subject to NIIT. The truth of NIIT is that it stands in its own little chapter of the Code and is quite apart from the income tax rules. Since whatever income tax rules normally apply have no impact here, a discussion requires starting from ground zero to determine the taxable income and apply the tax rate to it for NIIT.

First of all, what is a dividend? A dividend for net investment income definitions is a distribution from the earnings and profits of a corporation and for net investment income. It does not matter whether the distribution came from previously taxed earnings and profits or previously untaxed earnings and profits because it is all same old dividends exclusively for NIIT purposes. Thus, anytime there is a distribution from a CFC to an individual shareholder, the 3.8 percent NIIT[16] is going to apply. This is true for someone who made the § 962 election or did not.

Next, assuming the individual taxpayer made the § 962 election, the

16) The taxpayer would put 100 percent of the dividend received into the NIIT box on Form 8960, "NIIT Individuals, Estates, and Trusts", do the calculations and then drop the net tax liability onto Schedule 2, Line 14 of Form 1040. Back to our assumption of $1,000,000 of taxable income at the corporate level, paid tax of $250,000, and then distributed 100 percent of the excess cash in the corporation, $750,000 as a dividend, all in one year. From Part III of Form 8960, after the math on Lines 13, 14, 15, 16, then calculates the NIIT on Line 17. That goes over to the Form 1040.

income tax issue should be discussed on this $750,000 dividend coming out of the Korean corporation: How much of that $750,000 is included in gross income and, along the way, is this ordinary income or a qualified dividend? § 959(a)(1) "Exclusion from Gross Income of U.S. persons" is the one that says distributions of previously taxed earnings and profits are not included in the gross income of individual shareholders, and the following shows how the default rule for distributions in § 959 is overruled. Treasury Regulations § 1-962-3(b)(1), companion to § 962(d), provides as follows:

> Earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a U.S. shareholder under § 951(a) with respect to which an election under this section applies when such earnings and profits are distributed, notwithstanding the provisions of § 959(a)(1), be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid under this chapter on the amounts to which such election applied.

With the dividend received, the taxpayer would compute how much of the dividend should be excluded from the gross income and how much of that dividend the taxpayer should include in gross income. § 962 election in the way it phrases the formula for the math problem anticipates that some of the distribution will be excluded from gross income, which is favorable to the taxpayer.

The first thing is to figure out the CFC's "§ 962 earnings and profits," and this is the same as regular corporate earnings and profits. It is the earnings and profits accrued during a year in which the § 962 election is made. Assuming that all $1,000,000 of net profit at the Korean corporation was earned in a year that the U.S. shareholder made the § 962 election, the maximum possible distribution is going to be $750,000 because the Korean corporation paid $250,000 in Korean corporate tax. How much of that $750,000 is going to be taxable, and what is the formula for calculating the taxable distribution amount in Treasury Regulations § 1.962-3(b)(1) for the distribution of $750,000? Then compute the excludable § 962 earnings and profits, which translates as the federal income tax the U.S. shareholder actually paid on earnings and profits inclusions because of § 951(a) and

951A(a). The taxpayer would subtract that, and whatever is leftover is the taxable portion of the distribution or taxable § 962 earnings and profits, which would be the U.S. shareholder's final taxable dividend income on Form 1040.

The amount of tax paid on § 951(a) and 951A(a) inclusions is the excludable amount of dividend received when the taxpayer makes a § 962 election. Under § 962(d), when such earnings and profits are distributed, the taxpayer would include them in gross income to the extent that such earnings and profits (which is the amount distributed to the shareholder) exceed the amount of tax paid under the income tax chapter on the amount to which § 962 election applied. The legislative history of the 1962 tax law (changed in Internal Revenue Cumulative Bulletin 1962[3] to originally introduce § 962) shows how to calculate all the relevant amounts. If the literature is read carefully, "tax paid"[17] is the actual tax payment in dollars to the IRS after the foreign tax credit. What does "tax paid" mean? The "paid" means simply "paid."

§ 962, when it says the excludable portion is the taxes paid, and then Form 1040, Line 12a through Line 18 illustrates how much tax the taxpayer paid. Here is the math to compute the tax liability on the pass-through income, whether it is Subpart F or GILTI income, which goes on Line 12a. The tax liability on § 951A income is followed by allowable foreign tax credits on Line 13b. Then, on Line 16 comes the taxpayer's "total tax." Since the § 960 indirect foreign tax credit fully offsets the tax liability in Exhibit 2, the "total tax" is zero.

The taxpayer's previous cash payments including other refundable credits can be listed on Lines 17 and 18. If the foreign tax credit reduces the total tax to zero as in Exhibit 2, then the taxpayer's total cash payments on

17) *See* C.B. 798-799 1962 ("… If an individual has elected with respect to the earnings of a controlled foreign corporation to be treated as if he were a domestic corporation, and then subsequently an actual distribution is made, the bill provides that he then is to be taxed only on the excess of the amount received over the amount of taxes he previously paid with respect to the undistributed income. Therefore, if the individual were to be taxed on $100 of undistributed income at a 52 percent tax rate, and then subsequently the $100 was paid to him as a dividend, he would be taxed at individual income tax rates only on $48, namely, the excess of the amount distributed to him over the taxes he previously paid, assuming the foreign country involved had no income taxes.").

Lines 17 and 18 are to be zero. That makes the taxpayer's "excludable" distribution amount equal to zero for § 962(d) purposes. Line 13b is going to be the allowable foreign tax credit to offset that tax liability on Line 12a, and then, rumbling down a few more lines, Line 16 calls for total tax, which is the taxpayer's tax liability. According to Exhibit 2, the tax liability of $105,000 is to be listed on Line 12a, and then a foreign tax credit of $105,000 is listed on Line 13b because § 960 allows that. Therefore, the total tax on Line 16 is equal to zero. And here is the critical part where Lines 17 and 18, what the IRS calls payment, are either a refundable credit or cash money previously paid to the IRS by the taxpayer. Since there is no cash money in Exhibit 2, the excludable amount of dividend received is zero in calculating under § 962(d).

In Exhibit 3, the Korean corporation made a profit of $1,000,000 and paid a Korean corporate tax of $250,000, which resulted in earnings and profits of $750,000 followed by the excludable portions of § 962 earnings and profits in Exhibit 4. It is assumed that the cash balance within the corporation is the same as the balance of its earnings and profits and all the cash is distributed to the U.S. shareholder.

Since a § 250 deduction[18] is only allowable for § 951A GILTI income, starting with $750,000 of income inclusion (which is going to come off Form 8992), the subsequent § 78 gross-up for Korean taxes paid, and after § 250 deductions, $1,000,000 is going to come off Form 8993 taxable income. Since the taxable income is $500,000 and the U.S. income tax liability is at 21 percent for someone who made the § 962 election, the subtotal of tax paid is

**Exhibit 3.** Distribution of § 962 Earnings and Profits

| Items | Amount |
|---|---|
| Gross § 951A Income | $1,000,000 |
| (-) Korean Corporate Income Tax Paid by Korean Corporation | ($250,000) |
| Earnings and Profits of Korean Corporation | $750,000 |
| Assumed Distribution of Cash to U.S. Shareholder | $750,000 |
| All the Cash Distribution from § 962 Earnings and Profits | $750,000 |

18) Recall that no § 250 deduction is allowable for § 951(a) Subpart F income.

**Exhibit 4.** Excludable § 962 Earnings and Profits

| | § 951(a) | Taxes Paid |
|---|---|---|
| Tested Income Included in Gross Income by § 951A | $750,000 | |
| § 78 Gross up for Korean Taxes Paid | $250,000 | |
| Taxable Income before § 250 Deduction<br>(-) § 250 Deduction | $1,000,000<br>($500,000) | |
| Taxable Income | $500,000 | |
| U.S. Federal Income Tax Liability at 21% Corporate Rate | | $105,000 |
| Korean Corporate Income Taxes Paid | $250,000 | |
| Foreign Tax Credit Allowable after § 960(d) Limit | $200,000 | |
| § 904 Limit* | $105,000 | |
| Foreign Tax Credit Allowed under § 901 | | ($105,000) |
| Excludable § 962 Earnings and Profits = "Taxes Paid" | | 0 |

* § 904 Limit = Min [§ 960(d) Limited Tax, U.S. Tax Liability]

$105,000. Let us look at what "taxes actually paid" means here for the purpose of calculating the excludable amount of the dividend. In real life, the Korean corporation paid $250,000 in Korean corporate income tax, and $200,000 is the § 960(d) limit in allowing the taxpayer to take a deemed foreign tax credit for 80 percent of whatever was actually paid by the foreign corporation on GILTI inclusion. And finally, § 904 limit applies, which is the lesser of that 80 percent number of the actual U.S. tax liability. Here, the actual tax liability is going to be $105,000, and the allowable foreign tax credit under § 901 is $105,000. The § 904 limit and the allowed foreign tax credit under § 901 are going to offset each other, and the actual tax paid is going to be zero. Then, the excludable § 962 earnings and profits are going to be zero as well. Therefore, the distribution of § 962 earnings and profits will be 100 percent taxable as illustrated in Exhibit 5.

To be clear on this, the distributions from the CFC to the U.S. shareholder are treated as a legitimate distribution dividend from the CFC to the shareholder. It does not go through § 962, an election where the human taxpayer would pretend it was received by a domestic corporation in computing tax liability. In Exhibit 5, as soon as $750,000 was distributed and with zero excludable distribution of § 962 earnings and profits, the

**Exhibit 5.** Taxable § 962 Earnings and Profits

| Item | Amount |
| --- | --- |
| Distribution of § 962 Earnings and Profits | $750,000 |
| Less: Distribution of Excludable § 962 Earnings and Profits | $0 |
| Distribution of Taxable § 962 Earnings and Profits | $750,000 |

amount of taxable § 962 earnings and profits, a.k.a. dividend income, is $750,000.

In *Smith v. Commissioner*, 151 T.C. 41 (2018), a case[19] involving U.S. domestic grantor trusts, an S corporation, and CFCs incorporated in Hong Kong and later in Cyprus, the Tax Court said that the taxable distribution is included in the shareholder's gross income. It is not taxed as if received by a domestic corporation, then paid as a dividend to the individual shareholder. It is a dividend because it is a distribution of earnings and profits from a corporation to a shareholder. It is a qualified dividend if the CFC is a "Qualified Foreign Corporation"; otherwise, the dividend is taxed at the ordinary income tax rate.

Back to Exhibit 5 with this Tax Court decision in mind, it is a dividend, so that is the character of the income received; that $750,000 is going to be a dividend because it is a distribution of earnings and profits, and it is a qualified dividend if the Korean corporation is a qualified foreign corporation. Then, it is going to be a dividend subject to extraordinary tax rates. In Exhibit 5, it is assumed that it is going to be an ordinary dividend applying ordinary income tax, not a qualified dividend.

Following the discussion so far, what is going to happen to the dividend income? How much is the excludable part? Zero. How much is the includable part? All of it, or $750,000, is includable, and that $750,000 is going to go to Schedule B like any other dividend income, and it is going to go on the front page of Form 1040 as ordinary dividend income and into taxable income and, finally, the U.S. shareholder is going to compute the tax liability on it as an ordinary income at the ordinary tax rate. By contrast, if it was determined to be a qualified dividend, the amount would be put in

19) *See* Smith v. Commissioner of Internal Revenue, 151 T.C. 41 (2018).

Box 3a on Form 1040 and the tax liability computed on the worksheet, and then that number ported onto Line 12a of Form 1040 as the summary or conclusion of that worksheet.

Therefore, if the U.S. shareholder were to step back without the § 962 election, the entire $750,000 of cash distribution would come to the shareholder tax-free. With the § 962 election, the $750,000 of cash distribution is included in gross income and is taxed, currently. The taxpayer would see how it all balances out, particularly the impact of the indirect foreign tax credit against the deemed income inclusions of Subpart F and GILTI income on the one side, but all are partially offset by more income tax liability because the shareholder would get dividend income.

There's no easy answer, but the taxpayer would have to find out just by doing the numbers. As a U.S. individual shareholder living in Korea, which has a robust personal income tax system where the taxation rates are roughly equivalent to U.S. rates, paying income tax on that dividend income in Korea and taking a foreign tax credit in the U.S. for foreign income taxes paid in Korea, in theory, should offset. The § 962 election is going to make a lot of sense; therefore, this is going to be the taxpayer's default starting assumption.

On Line 12a of Form 1040, the individual income tax liability of $330,000 would be recorded, of which $105,000 is the income tax liability computed on GILTI, which pass-throughs. And the rest of it is the income tax liability on the dividend received, which adds up to $330,000. Then at Line 13b, there will be a number with the exact offset because Form 1118 has a $105,000 allowed indirect foreign tax credit, and Form 1116 has a $225,000 allowable direct foreign tax credit. Then, matching Lines 12b and 13b and subsequent subtraction results in a zero on Line 14. Line 15 is the NIIT, and that is going to be the result of the § 962 election for a person operating a business and living in Korea. Then, except for the NIIT of 3.8 percent on the dividend income, everything works out nicely for this U.S. shareholder living in Korea. And this is why for somebody who is coming from any high-tax country such as Korea, it may be a reasonable guess that the number is going to work out favorably for this taxpayer with the § 962 election. And the § 962 election is also favorable in that situation because it has nothing to do with the Korean tax situation, as it is purely a U.S. income tax election that will not touch the structure, will not touch the ownership,

and will not make an impact on the income tax liability situation in Korea at all.

## VI. Specific Foreign Company and Foreign Tax Credit Rules in Korea

In the previous section, we went through the numbers where we included dividend income and gross income and calculated a tax liability that ended up as part of the number on Line 12a of Form 1040. Now, the allowable foreign tax credit is computable on Form 1116, "Foreign Tax Credit - Individual, Estate, or Trust" because this is tax actually and directly paid by the U.S. shareholder. This is not the indirect foreign tax credit, and it goes on Form 1116.[20)]

Assume our Korean CFC for U.S. tax purposes diversified its manufacturing and selling merchandise produced by its domestic and foreign subsidiaries including sub-subsidiaries. Assume also its foreign holding company located in Country A received tax refunds and other benefits as a tax holiday for newly established companies when filing a corporate tax return in 2022. Foreign holding company A paid dividends to our Korean parent CFC, and there was no withholding tax on the dividend income in the resident country due to the zero-dividend withholding tax rate. When foreign holding company A reports corporate tax attributable to the resident country in 2022, a deemed foreign tax credit as stipulated in the relevant tax treaty is not applicable in this case. If foreign holding company A established with 100 percent investment by a Korean CFC is subject to the tax reduction or exemption for newly established companies when filing a corporate tax return in the resident jurisdiction in 2022, the dividend income paid by the corporation to its corporate shareholders cannot be regarded as income subject to the deemed foreign tax credit as stipulated in Article 57(3) of the Corporate Tax Act, Article 57(3) of the Income Tax Act, as well as the relevant articles in the tax treaty.

In relation to the application of the provisions of "Consideration of

---

20) It is less normal that an individual tax return that Form 1116 and Form 1118 is attached to it, but it happens.

Retained Earnings of Specific Foreign Corporations as Dividends" pursuant to Article 27 of the Adjustment of International Taxes Act (hereinafter "the Act"), if it is impossible to receive dividends from a specific foreign corporation, for instance, a sub-subsidiary B, due to the large accumulated losses of foreign holding company A of the Korean parent CFC, a question arises as to whether the provisions of this Article 27 apply to the retained earnings available for dividends of the sub-subsidiary company when actual dividend payouts are not possible due to the large accumulated losses. A reasonable answer might be that the amount calculated by multiplying the amount of retained earnings available for dividends calculated in accordance with Article 27 of the Act and Article 66 of the Enforcement Decree of the Act by the shareholding ratio of Korean tax residents is deemed to have been received by the same tax resident. If a Korean tax resident directly or indirectly owns at least 20 percent of the shares of a specific foreign corporation pursuant to Article 27, the amount calculated by multiplying the shareholding ratio is considered to be a dividend received by the Korean tax resident.

Article 57 "Foreign Tax Credit" of the Income Tax Act provides for a foreign tax credit system. Previously, there were two methods of claiming relief for foreign taxes paid: A taxpayer could either utilize foreign taxes paid as (1) credit against calculated tax assessment subject to limits; or (2) deduction as an expense. Though the alternative to deducting foreign taxes paid for corporations was recently repealed, the foreign tax credit carry-forward has been extended from 5 to 10 years, and any unused tax credits can be expensed[21] in the year following the 10-year period.

In more detail, the foreign tax credit method should be applied to a foreign-source income tax deduction on global income other than business income through the following methods: (1) deduct the foreign tax credit amount from that as the amount on global income limit as calculated as the amount of global income tax multiplied by the ratio between the amount of foreign-source income and the global income; (2) where the foreign-source income is deducted from the calculated tax on global income and the foreign income tax paid or payable to a foreign jurisdiction exceeds the

21) These revisions will apply with respect to foreign tax credits that have not lapsed as of the end of 2020.

credit limit, such excess may be carried forward to the taxable period to be completed within 10 years. Then, deduct within the credit limit for the taxable period to which it is carried forward; and (3) in calculating the (limits of) deduction of the foreign tax credit, the method of separate calculation for each country should be adopted if the foreign places of business are in two or more jurisdictions. Otherwise, a domestic tax resident with business income could include a foreign income tax amount on the foreign-source income paid or payable in necessary expenses in the calculation of income in the relevant taxable period.

'The Amount of Direct Foreign Income Tax Imposed by a Foreign Jurisdiction' means: (1) the amount of excess profit tax, value-added tax, and other taxes imposed with other income of the corporation as the tax base; and (2) the amount of tax imposed with the amount of earnings, other than income, as the tax base and other corresponding taxes falling under the same tax items as the tax base, excluding additional taxes[22] and surcharges. Alternatively, an equivalent amount of the corporate tax reduction or exemption to a Korean corporation having foreign-source income in a tax treaty country is the deemed amount of foreign tax for which the Korean corporation is entitled to a tax credit or inclusion in deductible expenses within the limits stipulated by the relevant tax treaty.

'The Specific Foreign Company[23] Rule' is intended to deal with a situation where a domestic tax resident establishes a foreign corporation in a low-tax jurisdiction to defer domestic income tax as reserving its earnings

---

22) Having all those taxes of income tax and local income tax in global tax calculation, the taxpayer could be eligible to deduct an amount equivalent to 10 percent of such deducted amount from the calculated individual local income tax according to the current Article 97 of Foreign Tax Credit for Global Income and Article 167-2 of Tax Credit, Reduction or Exemption from Individual Local Income Tax of the Restriction of Special Local Taxation Act when the tax credit was applied in the calculation for the global income tax. Thus, the taxpayer has benefit of additional local tax deduction effect of 10 percent of the foreign tax paid despite the taxpayer has not paid the local tax at the foreign country. This could be against the initial purpose of adjusting the double taxation, but the taxpayer could deduct the local tax amount despite the taxpayer has not paid the local tax at the foreign country as there are no separate rules to restrict those.

23) This rule may be read in comparison with a "Specified Foreign Corporation," which is any CFC under I.R.C § 965(e)(1)(A) and any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder stipulated under § 965(e)(1)(B).

and profits within the corporation. Article 27 of the Act is applicable when a domestic tax resident invests in a foreign corporation with its head office or main office in a jurisdiction where the tax burden of the corporation is 70 percent[24] or less of the Korean corporate income tax determined under Article 55 of the Corporate Tax Act.

For foreign corporations that have a special relationship with domestic tax residents, the amount to be reverted among the retained earnings that can be distributed at the end of each taxable year is deemed to have been distributed to the domestic tax resident. While the scope of 'Domestic Tax Resident'[25] includes a person who directly or indirectly owns 10 percent or more of the total issued stock or total investment as of the end of each taxable year of a specific foreign corporation, the 'Special Relationship'[26] is constituted by equity investment including a common interest. There is room to be judged as having a special relationship with an investment of 10 percent of the total issued stock; as the parties to a transaction have a common interest and one of the parties to the transaction can substantially determine the business policy of the other, they may be considered to have a special relationship. Under Article 2(1)(3) of the Act, a special relationship is based on the equity interest by including stocks of non-residents in a kinship and economic relationship with a special relationship under Article 2(20)(a and b) of the Framework Act on National Taxes in the calculation. This rule was amended to apply even if a domestic tax resident made a direct or indirect investment of 50 percent or more in a foreign corporation in combination with a non-resident with a special relationship in taxable years beginning January 1, 2013. The deemed dividend rule is applicable even in the case of distributed investment through a specially related

24) The actual corporate income generated is the sum of taxes on the total net income before deduction of corporate tax for the last 3 taxable years, including the relevant taxable year, according to the tax law of the residence jurisdiction. The amount of tax actually paid includes the amount of tax paid in a jurisdiction other than the jurisdiction of residence on the actual income of the relevant corporation. Article 8 of the Enforcement Decree of the Act refers to the net income before deduction of corporate tax calculated according to the generally accepted accounting principles ("GAAP") when preparing financial statements in the country of residence of the corporation.

25) Gukjejosejojeongbeop [Adjustment of International Taxes Act], art. 27 para. 2 (S. Kor.).

26) Gukjejosejojeongbeop [Adjustment of International Taxes Act], art. 2 para. 1 subpara. 3 (S. Kor.).

person by judging whether the sum of the dispersed investment by the domestic tax resident in a foreign corporation through such a kinship a person.

As the specific foreign corporation actually operates the business, is a wholesale business, or is classified as a foreign holding company subject to certain conditions, the deemed dividend rule does not apply except for listed specific business types.[27] In addition, if the passive income of a specific foreign corporation exceeds 5 percent of the gross income, the relevant income is deemed to be available for dividends to which the rule is currently applicable. However, under Article 28(2) of the Act, this deemed dividend rule does not apply if a corporation maintains fixed facilities such as offices, stores, or factories necessary for business in a low-tax jurisdiction, and conducts actual business operations by managing, controlling, or operating the business on its own. Under Article 65 of the Enforcement Decree of the Act, passive income of stocks or bonds of a specific foreign corporation is not subject to the deemed dividend rule when it falls under a category of conducting actual business or a special exception to the scope of wholesale[28] business. If the income generated from ownership, the provision of intellectual property rights, the rental of ships, aircraft, or equipment, investment trusts, or investments in funds exceeds 5 percent of the gross income of the corporation, the relevant income is classified as reserved earnings and profits and is subject to the dividend count. However, if the specific foreign corporation owns 10 percent or more of the

---

27) If the specific foreign corporation is in the wholesale, finance and insurance, real estate and rental, professional, scientific and technical service business (excluding building technology, engineering and related technical service business), business facility management and business support and the proportion of the wholesale business exceeds 50 percent of the total revenue or total purchase cost with a related person of the corporation, and the total revenue generated from the above wholesale business or the total purchase cost exceeds 50 percent of the total income generated in these industries or the sum of the total purchase costs, the rule is applied again. In addition, if the main business of specific foreign corporation is holding stocks or bonds, providing intellectual property rights, leasing ships, aircraft, and equipment, and investing in investment trusts or funds, the exemption category from taxation due to actual business operation is not applicable.

28) If the amount sold by a specific foreign corporation engaged in wholesale business to an unrelated person in the same jurisdiction such as E.U. or China and Hong Kong exceed 50 percent of total sales, the retained earnings dividend rule does not apply.

stocks of another foreign corporation, dividends from those stocks are excluded from the gross income.

Under Article 28 of the Act, if a specific foreign corporation whose main business is a foreign holding company and holds stocks of its subsidiaries, the deemed dividend rule does not apply if the business is operated through fixed facilities and meets all of the following requirements: (1) the foreign holding company holds the stocks of its subsidiaries continuously for at least six months as of the date of dividend; and (2) the ratio of the sum of interest and dividend income received by the foreign holding company from the subsidiaries having its head office or main office in the same jurisdiction in the foreign holding company's income is at least 90 percent.[29] The requirements for subsidiaries of a specific foreign corporation are such that it must be a corporation in which a parent corporation has invested more than 40 percent[30] and is not subject to the deemed dividend rule for retained earnings of a parent corporation.

Under Article 66(1) of the Enforcement Decree of the Act, when the retained earnings of a specific foreign corporation are subject to a dividend count, the distributable retained earnings in each taxable year are generally recognized when preparing the financial statements in the residence jurisdiction of the specific foreign corporation. The distributable retained earnings are calculated by deducting the amount in items (B) below after adjusting the items in (A) from the retained earnings by including the interim dividend from the disposal of retained earnings during the current taxable year according to established accounting principles.

(A) The amount to be adjusted for retained earnings before disposal is as follows:

---

29) Any income from the sale of shares of subsidiaries is excluded if a corporation maintains fixed facilities such as offices, stores, factories, etc., and conducts actually operating businesses other than those excluded from the application of the deemed dividends rule under Article 28(2) of the Act through those facilities.

30) Because it is impossible for resource development industries to hold more than 50 percent of the shares due to the local regulations of the relevant jurisdiction, the investment ratio requirement has been amended from the previous 50 percent or more to the current 40 percent or more and is applied from the taxable year after February 18, 2010.

(a) including the amount treated as a voluntary reserve among the details of the disposal of retained earnings before the relevant taxable year; and
(b) excluding the amount treated as voluntary reserve transfer from the statement of disposal of retained earnings before the relevant taxable year.

(B) Items to be deducted from retained earnings before disposal are as follows[31]:

(a) dividends of profits among the disposal of retained earnings for the relevant taxable year (including interim dividends from the disposal of retained earnings) or the distribution of surplus;
(b) bonuses, retirement benefits, and other outflows from the disposal of retained earnings for the relevant taxable year;
(c) disposal of mandatory reserves or mandatory retained earnings determined by the laws and regulations of the jurisdiction of residence among the amount of disposal of retained earnings for the relevant taxable year;
(d) the residual amount32) that has not been disposed of as retained earnings pursuant to (a) above among the previously taxed income is deemed to have been distributed to the relevant domestic tax resident under the deemed dividend rule before the starting date of the relevant taxable year;
(e) the amount of retained earnings (excluding unrealized stock valuation gains) that has not been disposed of under (a) and (b) above when the deemed dividend rule is not applied;
(f) unrealized amount of stock valuation gains as of the end of the relevant taxable year; and with
(g) the exclusion threshold of 200 million Korean won as the

31) However, if the GAAP in the jurisdiction of residence is significantly different from the Korean GAAP, adopt the amount obtained by adjusting the above (B) from the retained earnings before disposal calculated by applying the Korean GAAP and the amount obtained by subtracting the amounts in (a) to (g) shall be regarded as distributable retained earnings.

32) An amount of taxable deemed dividend.

application of dividends for a small amount of retained earnings.

Under Article 66 of the Enforcement Decree of the Act, the deemed dividend amount is calculated by multiplying the reserved earnings and profits available for dividends of specific foreign corporations by the shareholding ratio of domestic tax residents to the corporations concerned. Under Article 67(1) of the same Decree, when one or more corporations are interposed between a domestic tax resident and a specific foreign corporation through equity investment and they are all connected in a tiered equity holding, the percentage of the stock ownership of a specific foreign corporation by the domestic tax resident is calculated by multiplying all the stake ratios in each tiered stage. Therefore, not only foreign subsidiaries, but sub-subsidiaries reinvested by foreign subsidiaries may also be subject to the count of the deemed dividends.[33] If the foreign subsidiary is a mere paper company without human or physical substance, piercing the corporate veil may happen following the principle of substantive taxation under the Framework Act on National Taxes and Corporate Tax Act, and the foreign subsidiary will not be deemed to be affiliated with the domestic tax resident. Since the income and expenses of each taxable year of the nominal foreign subsidiary are added and reported as the profit and loss of the domestic tax resident, Article 17 of the Act on the deemed dividends of specific foreign corporations does not apply.[34]

Under Article 67 of the Act, the deemed dividend is included in gross income or dividend income for the taxable year of a domestic tax resident to which the 60th day from the day following the end of the relevant taxable year of a specific foreign corporation belongs. Under Article 33(2) of the Act, when a specific foreign corporation actually pays dividends to a domestic tax resident, the amount considered to be a dividend in the taxable year is included in gross income if there is previously paid tax to a foreign jurisdiction, which can be deducted as the amount of direct foreign

---

33) In case of reinvestment, the current investment status in foreign subsidiaries must be filed on the Specification of Foreign Subsidiaries Report.

34) National Tax Tribunal, Reply to Inquiry 46017-102 (July 27, 2000). If one or more domestic corporate entities are interposed between a domestic tax resident and a specific foreign corporation through tiered stock ownerships, the deemed dividend is not calculated between domestic tax residents.

tax paid. A domestic tax resident who intends to apply for this may request a correction within one year from the filing deadline for income tax and corporate tax in the taxable year in which the dividend is actually received. When applying for the indirect foreign tax credit under Article 57-2 of the Corporate Tax Act, the amount considered to be a dividend under the deemed dividend rule shall be regarded as dividend income and included in the gross income for the taxable year.

Under Article 68 of the Act, if the retained earnings of a specific foreign corporation are included in the gross income of domestic tax residents and if the corporation actually distributes[35] the retained earnings, it is deemed not to fall under dividend income and shall not be regarded as income carried forward under Article 18(2) of the Corporate Tax Act or Article 17(1) of the Income Tax Act. If the domestic tax resident transfers stock of the specific foreign corporation after the retained earnings are included in the gross income, an amount equivalent to the sum of the dividends considered for the transferred stock minus the amount actually distributed for the transferred stock is deemed to be carried forward[36] or not deemed to be the capital gains under Article 118-2 of the Income Tax Act. In this case, if the amount deemed to be carried forward or not deemed to be capital gains exceeds the gains from the transfer of the relevant stock, the amount in excess shall be deemed not to exist.

Under Article 98 of the Enforcement Decree of the Act, a domestic tax resident who is subject to the deemed dividend rule of a specific foreign corporation must file the following documents with her tax return:

(1) financial statements, statements of retained earnings, statements of determination of combined taxation of retained earnings, and statements of determination of the scope of application of combined taxation of retained earnings of specific foreign corporations;
(2) corporate tax returns and accompanying documents required by the taxation authority of the resident jurisdiction of the specific foreign

35) Including dividends or distributions under Article 16 of the Corporate Tax Act.

36) The books and certification documents necessary for the calculation of the gross income carried forward shall be preserved until the statutory filing deadline of the taxable year in which the dividend or transfer date belongs.

corporation; and
(3) statements of foreign investment.

For specific foreign corporations under Article 28(1), for wholesale businesses under Article 29(2), and for foreign holding companies under Article 28(2) of the Act, Statements of Determination including the scope of application of combined taxation of retained earnings of the specific foreign corporation must be filed[37] as well.

With the above Korean foreign tax credit rules in mind, let us revisit Exhibit 5. The taxpayer's foreign tax credit limitation at the end of the day was $105,000, even though the available foreign tax credit was $200,000[38]. But the story doesn't just stop here because there may be a de minimis implication which would be worthwhile to consider if there exist U.S. shareholder's expenses allocable to GILTI of $750,000. In case the shareholder has a big management structure back to the U.S. with some R&D and interest costs, those expense items can reduce the amount of Korean-source taxable income. Since the foreign tax credit limitation formula here is U.S. tax before foreign tax credit times Korean-source taxable income over worldwide taxable income, the expenses of the U.S. shareholder that are allocable against this GILTI income would cause net earned Korea-source taxable income for the formula to fall and subsequently reduces the available foreign tax credit limitation. The worldwide taxable income remains the same because the allocable expenses will not affect it, but the allocable expenses would affect the Korean-source taxable income.

---

37) From the taxable year beginning after January 1, 2014, a domestic tax resident fails to submit by the deadline for submission or fails to fill out all or part of the required to submit a statement of calculation of retained earnings for a specific foreign corporation, an amount equivalent to 0.5 percent of the retained earnings available for distribution of the foreign corporation is added as corporate income tax. Under Article 76(18) of the Corporate Tax Act and Article 81(13) of the Income Tax Act, the penalty tax will be collected even if there is no calculated tax amount.

38) Note that under § 904(c), the excess foreign tax credit limitation of $95,000 (= $200,000 – $105,000) is lost since there is no carryback or carry forward allowed for this $95,000. Since the potential carryback and carryover for this separate category of GILTI is not allowed, this can be a major economic issue to multinationals as they attempt to calculate the effect of GILTI on their situations.

## VII. A Hypothetical Dual Elections and the Potential Hybrid Mismatch Issues[39]

Through Action 2 of the 2015 Convention to Prevent Base Erosion and Profit Shifting ("BEPS"), the OECD addressed double non-taxation issues arising from mismatches in tax treatment between countries regarding expenses or income (the "hybrid mismatches"). It was also recommended to amend the domestic regulations to prevent hybrid mismatches due to transactions with reverse hybrid entities. Although certain U.S. regulations are in principle denying double deduction, it is limited to interest or royalties between related foreign hybrid entities that the scope of application is narrower than the Common Approach of BEPS Action 2. For instance, §§ 245A(e) and 267A deny a participation exemption for hybrid dividends including certain hybrid arrangements. A hybrid entity defined under § 267A(c) is one that is treated as fiscally transparent in the U.S. but not in another jurisdiction or vice versa.

An individual U.S. shareholder's incentive to avoid negative consequences from anti-deferral rules under §§ 951A and 951(a) or passive foreign investment company treatment under § 1297 may inadvertently trigger an issue of domestic reverse hybrid entity to an operating company in Korea by filing the foregoing § 962 election which allows direct U.S. taxation on the individual of the Korean entity's income and her direct claim of a foreign tax credit for the Korean taxes paid by the entity. Furthermore, any losses incurred within the Korean entity may be included in her U.S. tax returns and possibly offset[40] other taxable income.

Assuming an individual U.S. shareholder files both the § 962 election together with the entity classification ("Check-the-Box") election under Treasury Regulations § 301.7701-3 for a disregarded entity treatment to her

---

39) OECD, Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 (2015). Action 2 can be developed into a minimum standard in the future by proposing strong implementation among the 15 tasks of the BEPS Prevention Convention and corresponds to the task at the level of performance obligations of the Common Approach. A complete survey of the BEPS Prevention Convention is beyond the scope of this paper.

40) The recognition and treatment of such foreign losses may be subject to potential limitations and recapture, including §§ 1503(d), 904(f)(3), and 91.

personal holding company established under Korean law. With these elections, local legal status is ignored, and the U.S. income tax rules are applied as if the business operations of the non-U.S. entity and its assets were owned by the entity's sole member for U.S. tax purposes. Despite these elections, it is continued to be treated as a corporate entity that does not bear individual tax obligations in Korea. The idea of a personal holding company established under Korean law appears to be robust enough to take back any potential of dual resident issues.

According to Article 2 of the Corporate Tax Act, a domestic corporation refers to a corporation with its head or main office or actual place of management located in Korea. The logic in the Korean corporate tax law and its enforcement decree can be summarized in the contents of the relevant Supreme Court's decisions[41]: Under Article 13, Paragraph 4 of the Framework Act on National Taxes, in the case of a domestic association, foundation, or other organization without legal personality, corporate income tax must be levied once the organization has deemed a taxpayer under the Corporate Tax Act. Otherwise, income tax is levied according to the Income Tax Act. If it is a non-profit organization that does not distribute profits to its members, the organization must be regarded as a resident taxpayer and is subject to income tax. If it falls under a for-profit organization that distributes profits to its members, the organization is not regarded as a single resident liable to tax, but as stipulated in Article 87, Paragraph 1 and Article 43, Paragraph 2 of the former Income Tax Act, each member is subject to income tax on the amount of income distributed. When it comes to a foreign association, foundation, or other organization without legal personality falls under the for-profit organization that obtains domestic source income and distributes it to its members, the organization can be regarded as a foreign corporation under the Corporate Tax Act and is liable to corporate tax on the domestic source income. Otherwise, the members of the organization are liable to tax and the income tax liability arises for income distributed to each of them. Since the contents of the laws of the country in which the organization was established and the substance of the organization are judged in Korea, the decision should be made

41) Daebeobwon [S. Ct.], Jan. 27, 2010, 2010Du5950 (S. Kor.).

according to whether it can be seen as a subject of separate rights and obligations independent of its members.[42]

For U.S. tax purposes, which has accepted the U.S. shareholder's election not to grant independent legal personality to this Korean personal holding company, further consideration of the governing law for establishment may not be required. Because the personal holding company is a part of the individual U.S. shareholder or sole proprietorship of the U.S. individual, it will not be recognized as a dual resident for U.S. tax purposes. Therefore, even if the Korea-U.S. Tax Treaty ("Treaty")[43] is applied, this particular company may remain to be a dual resident unless the competent authorities from the two countries agree otherwise. For example, if an individual U.S. resident establishes a personal holding company under Korean law as a 100 percent-owned subsidiary and files a disregarded entity classification election under Treasury Regulations § 301.7701-3, the Korean personal holding company is no longer considered an independent legal entity for U.S. tax purposes but just a part of the U.S. resident. In other words, it is regarded as "a U.S. person's overseas branch" and is taxed on worldwide income including its subpart F income, GILTI, and other earnings and profits of a corporate entity. In the meanwhile, the same company in question is continued to be a domestic corporation as defined in Article 2 of the Corporate Tax Act, so it is liable to tax on its worldwide income again.

From its outbound administration perspective, the U.S. has denied the application of tax treaties to U.S. source income paid to foreign shareholders if invested in the U.S. through both domestic or foreign partnerships unless the country of residence of the foreign shareholders treats the partnership as a pass-through entity and is therefore subject to

---

42) The Supreme Court maintained the position in the subsequent ruling that corporate taxation is applied only to foreign corporations under the standards of the Corporate Tax Act, regardless of whether the organization is subject to member taxation in the country of establishment. A foreign organization should be judged from a judicial point of view such that whether it can be viewed as a separate entity with rights and obligations independent from members of the organization in the Korean judiciary. *See* Daebeobwon [S. Ct.], Sept. 26, 2013, 2011Du12917 (S. Kor.).

43) Article 2(1)(e) of the Treaty provides that any corporation may be regarded as a U.S. corporation if the governing law of establishment is the U.S. law even if a company has its head or main office in Korea.

U.S. tax laws. § 894 *"Income Affected by Treaty"* delivers the reverse hybrid prevention provision requiring a 30 percent withholding tax. § 267A "Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities" is a relatively new statute[44] dealing with hybrid mismatches, which covers both in- and outbound structures broadly by stipulating related reporting procedures in detail. Since § 59A imposes a base-erosion and anti-avoidance tax (BEAT) on certain corporations making payments to related foreign persons[45] and have no exception for Subpart F income or GILTI defined under § 951(a) or 951A, the provisions may apply to payments made by a U.S. shareholder to a related Korean entity that is treated as either Subpart F income or GILTI and subject to current income inclusion taxation. Under § 267A and Treasury Regulations § 1.267A, income paid to the personal holding company established under Korean law is not deducted from the U.S. shareholder's expenses in the event of hybrid mismatches[46]. In parallel, certain interest or royalties cannot be deducted under the provision to the extent that there is no corresponding income inclusion to the Korean entity under Korean tax rules. By the time the Korean personal holding company distributes to a U.S. shareholder, a certain portion may constitute the U.S. shareholder's previously taxed income but still be subject to net investment income tax rules, as discussed in Section V of this paper. Net investment income under § 1411 includes dividends less allocable expenses to the dividends. For individual U.S.

---

44) § 267A denies a deduction for interest and royalties paid to related parties in connection with a hybrid transaction, including amounts paid by or to a hybrid entity. Specifically, § 267(a)(3)(B) is a rule that disallows a deduction for a payment to a related person if the deduction is not taken into account for U.S. tax purposes, which limits to CFC-to-CFC payments as well as to accruals of royalties outbound from the U.S. in certain circumstances.

45) For purposes of these BEAT provisions, a related party is (1) any owner of 25 percent or more of the total voting power or value of the stock of the taxpayer; (2) any person who is related to the taxpayer or any 25- percent owner of the taxpayer within the meaning of §§ 267(b) or 707(b)(1); and (3) any other person related to the taxpayer within the meaning of § 482. A modified version of § 318 constructive ownership rules may apply for the determination of a related party.

46) A hybrid transaction defined under § 267A(a)(2) is one in which the payment of interest or royalties is not so treated under the laws of another jurisdiction. Treas. Reg. § 1.267A provides guidance on application of hybrid transactions, disregarded payments, deemed branch payments, reverse hybrids, and branch mismatch payments.

shareholders, this means that the tax rate applicable to a redemption taxed as a qualified liquidating corporate distribution may actually be 18.8 percent or 23.8 percent. In addition to Korean corporate as well as withholding taxes, the related parties may also be subject to reverse hybrid entity prevention regulations of either jurisdiction.[47)]

## VIII. Alternatives to § 962 and IRS Revenue Ruling 88-25

Whenever a U.S. shareholder has a pass-through income (Subpart F and GILTI) and any one of the following three things is applicable, namely (1) the Korean corporation is a CFC, (2) the shareholder is a U.S. shareholder, and (3) the Korean corporation has certain types of income, specifically § 951(a) Subpart F income or § 951A(a) GILTI, they do not have a pass-through income problem and the potential for double taxation. Therefore, it is wise to adopt a Korean pass-through entity instead of "Chusik Hoesa." The Korean-source income is taxed in the U.S., but the pass-through entity allows the U.S. shareholder to use the foreign tax credit to offset the added U.S. tax cost.

Several alternative structures are available for the § 962 election. If any Korean pass-through entity, instead of the C corporation-equivalent "Chusik Hoesa" under Treasury Regulations § 301.7701-2 "Business Entities; Definitions" is adopted, the Korean-source income is taxed in the

47) In case there exists difference economically between the real earnings of the Korean entity and what Korean tax authorities is estimating its proper earnings and profits would be. To go along with this difference and to recognize that there remain still some excess profits in the U.S. shareholder, there needs to be an adjustment to explain why there is such a difference. Because what is important to the Korean law is consistency, the only way it could happen in the mind of Korean authorities for tax purposes is that the Korean subsidiary had distributed the excess profit-equivalent amount to the U.S. shareholder. That distribution is not a deduction. So, it allows everything to be consistent in Korea. Even though this hypothetical case does not appear to result in the erosion of the U.S. tax base, which § 267A was intended to address, it may still be liable to reverse hybrid entity prevention regulations of another jurisdiction when it comes to subsequent correlative adjustments. Because the deemed distribution from the source of potentially disqualified related-party amount may have been paid by a hybrid entity in Korea, one possible interpretation could result in a denial of a decrease in U.S. shareholder's tax basis in the shares of Korean subsidiary from the U.S. perspective.

U.S., but the chosen pass-through entity allows the U.S. tax resident to use the foreign tax credit to offset his, her, or its added U.S. tax cost. Since foreign income is only taxed to U.S. shareholders of the CFC, GILTI high-tax election-eligible[48] foreign income is not taxed to the U.S. shareholder of the CFC. Alternatively, if a U.S. parent corporation-Korean subsidiary corporation structure is considered, the foreign income is taxed in the U.S., but the pain is less because the U.S. Congress wrote a series of rules to favor this type of structure.[49] However, if the established entity in Korea is already a "Chusik Hoesa," what else might the U.S. shareholder be able to do?

Under 2014 Delaware Code Title 8, Chapter 1, Subchapter XVII Domestication and Transfer § 390 "Transfer, Domestication or Continuance of Domestic Corporations" would be used when a "Chusik Hoesa" incorporated in Korea wishes to become a Delaware company without having to dissolve the Korean entity.[50] Continuation statutes such as § 388 of the Delaware General Corporation Law[51] and § 18-212 of the Delaware

48) The controlling U.S. shareholders of the CFC make an annual election to use the GILTI high tax exception by attaching a statement to the shareholder's federal tax return, which binds for all U.S. shareholders. If the election is made for GILTI, it also applies to any Subpart F income inclusions of the U.S. shareholders. The high tax exception applies in our taxpayer only if the CFC's effective Korean rate on GILTI gross tested income exceeds 18.9 percent (i.e., 21 percent times 90 percent) and the U.S. shareholder elects for that year to exclude the high-taxed income.

49) However, most of the time in real life, this is not useful because if a generic U.S. citizen or permanent resident living in Korea and running a regular type of business, for Korean tax purposes, it is not really beneficial to bolt a Delaware C corporation on top as a holding company of this individual's Korean business. It may simply end up creating a giant mess in Korea in a way. A parent-Subsidiary structure sometime works but for practical reason, the author personally will not use or recommend it except for some specific type of client situations.

50) While domestication is commonly allowed in the British Virgin Islands and the Cayman Islands, it is also permitted by law in Delaware and many other states in the U.S. – a notable exception being the state of New York – and the rules and procedures are somewhat similar between states. Domestication is also available between states within the U.S.

51) Under Delaware Code § 388(d), once the certificate of domestication is effective, the "Chusik Hoesa" is subject to all of the provisions of the Delaware General Corporation Law, and the existence of the corporation is deemed to have commenced on the date the "Chusik Hoesa" commenced its existence in Korea. Under Delaware Code § 388(j), the existence of the "Chusik Hoesa" remains intact following domestication: It is not required to wind up its affairs or pay its liabilities and distribute its assets, and the domestication does not cause or

Limited Liability Company Act deal with non-U.S. entities that wish to domesticate into Delaware. The "Chusik Hoesa" looking to domesticate in Delaware should file a certificate of domestication, accompanied by a certificate of incorporation with the Delaware Secretary of State. For a "Chusik Hoesa" to domesticate, it must be permitted both in its originating jurisdiction and in the destination jurisdiction in the manner provided by the governing documents of the entity. Otherwise, dropping either the property or the Korean entity itself into a new Delaware C corporation and liquidating the Korean entity may be considered. Since all these methods are essentially treated by the IRS as C or D reorganizations, the transaction should be tax-free,[52] except for any § 367(b) toll charge. Even if the Korean entity has accumulated earnings and profits, the inclusion at the time of repatriation is keyed to the earnings accumulated during the taxpayer's holding period.[53]

In Rev. Rul. 88-25, a foreign corporation became a U.S. domestic corporation by filing a certification of domestication under state law. As a result of the domestication, the corporation became subject to State law regardless of whether the corporation continued to exist under foreign law. The ruling held that the domestication was an inbound F reorganization, where certain transfers were deemed to take place. First, the "Chusik Hoesa" was deemed to transfer all its assets and liabilities to a domestic corporation in exchange for shares of the domestic corporation. Second, the "Chusik Hoesa" was deemed to liquidate by distributing the shares of the domestic corporation to its shareholders in exchange for the shares of its own stock. After the deemed transfers, the shareholders were treated as owning the shares in the U.S. domestic corporation again regardless of

---

constitute a dissolution of the "Chusik Hoesa". If the "Chusik Hoesa" that has become domesticated continues its existence in Korea, the corporation and the "Chusik Hoesa" shall, for all purposes of the Act, constitute a single entity incorporated and existing under the laws of the State of Delaware and the laws of Korea.

52) Treas. Reg. § 1.897-5(c)(4); C. B. 1044 IRS Notice 2006-46 2006. The domestication would not be adversely affected by the anti-avoidance rule of Treas. Reg. § 1.897-5(c)(4) — C.B. 403 IRS Notice 89-85 1989 and Notice 2006-46 — because Notice 89-85 would only require the "Chusik Hoesa" to pay an amount equal to any taxes that § 897 would have imposed on all persons who had disposed of interests in the "Chusik Hoesa".

53) Treas. Reg. § 1.367(b)-2(d)(3).

whether the "Chusik Hoesa" continued to exist under Korean law.

## IX. Conclusion

While it becomes a strong incentive not to use CFCs for U.S. tax residents, both § 951(a) and § 951A make a CFC's passive Subpart F income as well as active GILTI income mostly taxable to its U.S. shareholders, unless the corporation's income is subject to foreign tax at a high enough level. At the same time, both Code sections create immense complexity and overhead for accounting and tax compliance, susceptibility to errors, and probable penalties.

In a situation where a U.S. taxpayer already had a CFC in Korea, a check-the-box election to make it a disregarded entity that does not separate from its human owner may solve the problem. Alternatively, a check-the-box election would convert it to a Korean partnership, and that might solve some more problems here because it eliminates a lot of the complexity and overhead, if nothing else. However, if the entity was already formed as a "Chusik Hoesa" in Korea as listed as *Per Se Corporation* under Treasury Regulations § 301.7701-2 "Business Entities; Definitions," all the magic from the willow wand of check-the-box is not going to furnish its unusual healing power. The subsequent consideration is to register the "Chusik Hoesa" in the state of Delaware to accomplish U.S. domestication. All of a sudden, all the complexities of Subpart F and the GILTI issues go away.

The core aspect of our discussion in this paper was the availability of foreign tax credits. In high-tax countries such as Korea, § 962 election makes a lot of sense because the deemed-paid foreign tax credit eliminates U.S. income tax liability on both Subpart F and § 951A income inclusions, and the direct foreign tax credit eliminates U.S. income tax liability on dividend income. Unlike the 'no § 962 Election' tax return, distributions from a Korean CFC under § 962 election will create gross income. This creates additional taxable income for the individual U.S. shareholder. The U.S. shareholder may then be eligible to claim the direct foreign tax credit to offset some or all of the U.S. income tax liability from the dividend income. For other situations, meaning where a U.S. shareholder is operating in a

jurisdiction that has no individual income tax, the numbers with § 962 election may turn out badly for the taxpayer.