KPMG

TaxNewsFlash

United States

No. 2019-496
October 10, 2019

IRS Chief Counsel Attorney Memorandum advises election under section 952(c) is obsolete (implications for insurance companies)

In a recently released Chief Counsel Attorney Memorandum ("CCAM"), the IRS Associate Chief Counsel (International) concluded that the election out of the "same country exception" under section 952(c) is obsolete.

The guidance may have been issued in response to a concern that taxpayers could elect to treat insurance income as subpart F income and therefore avoid treating such income as global intangible low-taxed income ("GILTI") under recently enacted section 951A.

Read **Memorandum AM 2019-001** [PDF 2.3 MB] (released October 4, 2019)

Background

The arguments made in the CCAM are based on a historical review of the purpose and history of the section 952(c) election in the context of changes in the application of subpart F and the same country exception to insurance companies over the past 35 years. The CCAM divides this history into the "Pre-Same Country Era," the "Same Country Era," and the "Post-Same Country Era."

Pre-1986 (Pre-Same Country Era)

Before the Tax Reform Act of 1986, a controlled foreign corporation ("CFC") that was an insurance company included in subpart F income insurance income derived from the insurance of U.S. risks (as determined under section 953(a)). An insurance CFC's investment income, however, was generally excluded from foreign personal holding company income ("FPHCI"), and therefore from subpart F income, under former section 954(c)(4)(B) and (C), which provided a broad active financing exception from subpart F income. Subject to a cap on current earnings and profits ("E&P"), subpart F income could be reduced by current year deficits (the "current year E&P limitation"), accumulated deficits (the "accumulated deficit rule"), and current year deficits of other CFCs within the CFC's same chain of ownership (the "chain deficit rule").

1986-1998 (Same Country Era)

In 1986, Congress amended the subpart F rules because of concerns about the use of low-tax jurisdictions to shelter mobile and passive income and the use of losses to shelter income that would otherwise be subject to U.S. tax. Subpart F insurance income was expanded to include all insurance income (underwriting and related investment income) other than amounts that arose from insuring risks in the country where the CFC was created or organized (sometimes referred to as the "same country exception"). At the same time, Congress also repealed the active financing exception to FPHCI.

Additionally, Congress prohibited the use of prior year non-subpart F losses to offset subpart F income, and required the recapture of current year deficits in non-subpart F E&P that limited a subpart F inclusion. Congress restricted the use of deficits to offset subpart F income to "qualified deficits" that arose from the same "qualified activity" (which, in the case of an insurance CFC, meant subpart F insurance income or FPHCI), among other limitations. Thus, deficits from activities that did not generate subpart F income could be used only to create a timing benefit (in the case of the current year E&P limitation) or could not be used at all (in the case of the accumulated deficit rule and the chain deficit rule).

As a result, under post-1986 law, there was a mismatch between same country underwriting income (which was excluded from subpart F insurance income) and its related investment income (which was included in subpart F income as FPHCI). The changes to the deficit rules resulted in the systematic disallowance of underwriting losses of an insurance CFC that were clearly related to subpart F investment income inclusions, so that the U.S. shareholders of an active insurance CFC engaged in same country insurance could be subject to current taxation even after significant underwriting losses. The current year E&P limitation rule provided only temporary timing relief (i.e., as a result of the recapture rule) and required that the losses arise in the same year as the investment income. In addition, the accumulated deficit and chain deficit rules provided no relief because the non-subpart F same country underwriting losses did not meet the definition of a "qualified activity" even though they arose from the same business activity.

Congress enacted the section 952(c) election in 1988 to relieve some of the effects of the post-1986 changes to subpart F. It allows U.S. shareholders of insurance CFCs to elect to treat same country insurance income as subpart F insurance income. The effect is to allow same country underwriting losses to be offset against investment income, at the cost of treating all income from an active insurance business as subpart F income.

1998-Present (Post-Same Country Era)

In 1998, Congress again amended the rules that applied to insurance CFCs to address the mismatch of underwriting income and related investment income (the "1998 Amendments"). Specifically, Congress moved the same country exception in section 953 from subsection (a)(1)(A), added an exclusion from insurance income for "exempt insurance income" to (a)(2), provided an expanded and elaborated definition of exempt insurance income in subsection (e), and added the active financing exception ("AFE") for insurance companies to the FPHCI rules in section 954(i). [The IRS advice memorandum defines the AFE as including both section 953(e) and section 954(i)]. Under the AFE, investment income on exempt contracts plus a certain amount of surplus investment income was no longer subpart F income. Therefore, investment income attributable to insurance contracts that was exempt under section 953's definition of insurance income was no longer treated as subpart F income. Although the AFE was initially a temporary provision of the Code, it became a permanent provision in 2015.

Despite the addition of the AFE, the 952(c) election was nevertheless retained in the Code without modification, even after the AFE became permanent in 2015. As part of the 1998 Amendments,

Congress added a sentence to then-section 953(e)(10), which provided that if section 953(e) did not apply to a tax year of a foreign corporation beginning after December 31, 2001, then section 953(a) (including the same country exception) would be applied as if the tax year of the foreign corporation began in 1998 (i.e., under the law as it existed prior to the 1998 Amendments).

IRS analysis

The CCAM concludes that the section 952(c) election has been "inoperable" (in effect, dormant) beginning in 1998 because the purpose of section 952(c) was to allow taxpayers to treat insurance operations as subject to subpart F so that losses attributable to a CFC's active insurance operations could be offset against the insurance company's investment income, at a time when the AFE was not available to treat such income as exempt from subpart F. The CCAM argues that once the AFE was enacted in 1998, the section 952(c) election was no longer useful or necessary.

However, according to the IRS, it was necessary for Congress to leave section 952(c) in the Code because, until 2015, the AFE was only temporary. In the event that the AFE were allowed to expire, the section 952(c) election would again become relevant. Once the AFE became permanent, however, section 952(c) "lapsed into obsolescence" and became "surplusage." In support of this argument, the IRS relied on what it believed to be the plain language of the statute as well as the intent of Congress.

KPMG observation

The IRS's arguments for considering the section 952(c) election obsolete are unconvincing, for a number of reasons. The IRS's conclusion depends on a series of assumptions for which there is no evidence in the statute or in the relevant legislative history.

The first assumption is that following the enactment of the AFE, albeit on a temporary basis, in 1998, Congress intentionally left the section 952(c) election in the Code so that it would be available to taxpayers in the event that the AFE were allowed to expire. There are several problems with this assumption. First, there is no support for this theory in the legislative history. Second, the IRS claims that section 953(e)(10), which provided that if section 953(e) ceased to apply section 953(a) would be applied as if the tax year of the foreign corporation began in 1998, supports the conclusion that section 952(c) was retained so that if the AFE were allowed to expire the taxpayer could waive the same country exception. However, section 953(e)(10) only mentions section 953(a); it does not mention section 952(c). Furthermore, section 952(c) continued to cross-reference now-obsolete section 953(a)(1)(A), rather than section 953(a)(2) and section 953(e), where the same country exception was now codified.

Had Congress intended to allow the section 952(c) election to apply only in the event that the AFE were allowed to expire and the pre-1998 amendment same country exception applied, it seems likely that Congress would have either referred to section 952(c) in section 953(e)(10) (in which case, section 952(c) could have been safely deleted from the Code) or would have amended section 952(c) so that it only cross-referenced "former section 953(a)(1)(A)."

A far more plausible explanation of what happened is that Congress either forgot to repeal section 952(c) (if its intent was to repeal it), or forgot to fix the cross-reference to section 953(a)(1)(A) (if its intent was to continue to allow the section 952(c) election to apply to the same country exception as it existed in section 953(a)(2) and section 953(e)). As noted above, repealing section 952(c) would not necessarily have precluded the making of the election in the event that the AFE were allowed to expire, since Congress could simply have added a reference to section 952(c) in section 953(e)(10).

Given that no evidence exists that Congress intended to repeal the section 952(c) election following the 1998 Amendment, the sole question is whether the "broken link"—in which the Code cross-referenced a subparagraph of section 952 which no longer existed—means that the section 952(c) election was constructively repealed in 1998, even though a clear successor to the same country

exception survives, in section 953(a)(2) and section 953(e). In this regard, there is a substantial body of authority for the proposition that, in the case of a broken link, the intent of Congress to change a substantive provision must be "clear and manifest." See, e.g., *Tennessee Valley Authority v. Hill*, 437 U.S. 153 (1978).

The impression given by the CCAM is that the IRS sought to avoid what it perceives to be an abusive strategy by taxpayers, which is to make the section 952(c) election so that income of a foreign insurance company would become subpart F income rather than GILTI income. Aside from the fact that there is no reason to assume that such a strategy is abusive, there is also no evidence that Congress intended that the section 952(c) election would not be available to convert GILTI to subpart F income. The most obvious conclusion is that Congress did not think about it at all. Otherwise, Congress would have amended section 952(c) to fix the broken link.

For more information contact a KPMG tax professional:

Clarissa Potter | +1 (212) 872-6913 | clarissapotter@kpmg.com
Fred Campbell-Mohn | +1 (212) 954-8316 | fcampbellmohn@kpmg.com
Stuart Katz | +1 (212) 954-6674 | stuartkatz@kpmg.com
William Olver | +1 (617) 988-1642 | wolver@kpmg.com