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Global Tax Alert

US IRS Chief Counsel Advice concludes 952(c) election to include otherwise excludible insurance income in subpart F income of CFCs' US shareholders is obsolete

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In a Chief Counsel Advice Memorandum (AM 2019-001 or GLAM), released by the Associate Chief Counsel (International) on 4 October 2019, the United States (US) Internal Revenue Service (IRS) provides a legal analysis for determining the availability of the election under Internal Revenue Code[1] (IRC) Section 952(c)(1)(B)(vii)(I) (the 952(c) election), which would permit a US shareholder of a controlled foreign corporation (CFC) to include in subpart F income certain insurance income that would otherwise be excluded because it was attributable to the CFC's insurance activities in the country in which the CFC was created or organized (same-country exception).[2] Ultimately, the GLAM concludes that the 952(c) election "has been inoperable since 1998" and was made obsolete in 2015, even though the 952(c) election actually remains in the IRC.

The GLAM explains that the subpart F rules applicable to insurance companies have undergone significant legislative changes since 1986. The *Tax Reform Act of 1986* (the 1986 Act) enacted the same-country exception; another legislation package in 1988 enacted the 952(c) election; and the current version of the subpart F rules for insurance companies (the active financing exception (AFE)) was enacted in 1998. Because the 952(c) election "was a creature of" the same-country exception rules "that became defunct after AFE was made permanent" in 2015, the GLAM concludes that the 952(c) election is obsolete.

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Background

By its terms, the 952(c) election applies to insurance income that would have been excluded from subpart F income under prior Section 953(a)(1)(A) (the same-country exception). If made, the election treats such income as subpart F insurance income of the US shareholder. In 1998, Congress amended Section 953 without updating (or otherwise modifying) the cross-reference to Section 953(a)(1)(A) in the 952(c) election. While the 1998 amendment to Section 953 was intended to be a temporary provision, it was subsequently extended numerous times and made permanent in 2015.

The GLAM explains that the "IRS is aware that industry interest in the 952(c) election has arisen since certain practitioners have raised the possibility that it could be used to avoid" inclusions of income under Section 951A global intangible low-taxed income (GILTI) rules.[3] The IRS states that some have "posited that the election's cross-reference to the [same-country] exception in pre-1988 Section 951(a)(1)(A) should be re-interpreted and replaced with the exempt insurance income exception in Section 953(e)."

The arguments presented in the GLAM are based on a summary of the historical evolution of the treatment of insurance activities under the subpart F rules and the associated legislative history, as well as certain principles of statutory construction. The GLAM divides the treatment of insurance activities under subpart F into three distinct eras, discussed next.

Subpart F insurance rules before the Same-Country Era

Before enactment of the 1986 Act, Section 953 treated income derived from the insurance of US risks as a separate category of subpart F income. Under Section 954, dividends, interest, and gains on the sales of securities (among other items) were includable in a CFC's subpart F income as foreign personal holding company income (FPHCI). Section 954, however, included a broad exception that meant the investment income of an insurance CFC was generally excluded from FPHCI. Subject to a cap on current-year earnings and profits (E&P), subpart F income could be reduced by current-year deficits, accumulated deficits, and current-year deficits belonging to other CFCs within the same ownership chain (chain deficit rule).

Same-Country Era

As part of the 1986 Act, Congress broadened the reach of the subpart F rules for insurance company CFCs by amending Section 953 to provide that subpart F insurance income included any income attributable to the insurance (or reinsurance) of risks outside a CFC's country of incorporation. The exclusion from subpart F insurance income for consideration attributable to risk in the same country in which the CFC was created or organized was provided in former Section 953(a)(1)(A), and it was known as the "same-country exception." Congress further repealed the exception in the FPHCI rules for investment income attributable to the investment of insurance company reserves.

Believing that the deficit rules were too generous, Congress eliminated the chain deficit rule, prohibited the use of prior-year non-subpart F losses to offset subpart F income and required current-year deficits in non-subpart F E&P that limited a subpart F inclusion in a tax year to be recaptured in subsequent years. Congress further restricted the use of deficits to offset subpart F income to "qualified deficits" that arose from the same "qualified activity" and added other requirements for the use of these deficits. For certain insurance company CFCs, a "qualified activity" includes activities giving rise to Section 953 insurance income or FPHCI. Taken together, these changes meant deficits from activities that did not generate subpart F income could only be used to defer subpart F inclusions (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).

The changes coming out of the 1986 Act created a fundamental mismatch between the character of same-country underwriting income (which was excluded from subpart F income) and its associated investment income (which was subpart F income as FPHCI), despite that both types of income are part of an integrated insurance business. The current-year E&P limitation rule only provided a timing benefit due to the recapture rule, and it required that underwriting losses arise in the same year as investment income. The accumulated deficit and chain deficit rules provided no relief because non-subpart F underwriting losses did not meet the definition of "qualified activity," notwithstanding that they arose from the CFC's insurance business. Consequently, US shareholders of an insurance company CFC that engaged in same-country underwriting business may have had subpart F inclusions, even in the presence of substantial underwriting losses.

In 1988, Congress restored the chain deficit rule (although conforming it to the qualified deficit/qualified activity limitation found in the accumulated deficit rule) and enacted the 952(c) election. Citing the legislative history, the GLAM notes that the 952(c) election was enacted to give insurance

company CFCs "greater access to the new deficit rules" by allowing them to elect to treat same-country insurance income as subpart F insurance income. In this way, a CFC could utilize its underwriting losses (now as subpart F losses under the 952(c) election) against investment income (which continued to be subpart F income) under the deficit rules. Accordingly, the 952(c) election alleviated the systematic character mismatch problems from the 1986 Act between underwriting and investment activities of an insurance CFC.

Current AFE regime (post-Same-Country Era)

Congress amended the subpart F insurance income and FPHCI rules again in 1998 by expanding the same-country exception and restoring an exception to FPHCI for certain investment income of an insurance company CFC (the 1998 Changes). In particular, the exception for insurance income was relocated from 953 (a)(1)(A) to subSection (a)(2) and fundamentally expanded. Now subSection (a)(2) provides an exception from subpart F insurance income for "exempt insurance income," and subSection (e) defines exempt insurance income. Section 954(i) was codified to incorporate the new (and current) AFE for investment income, which generally provides that FPHCI does not include investment income allocable to exempt contracts (plus a certain amount of surplus investment income). As a result, certain investment income attributable to a CFC's insurance business is no longer treated as subpart F income as it was in the Same-Country Era.

The 1998 Changes were originally temporary provisions. In 1999, Congress amended Section 953(e)(10) to provide that, if Section 953(e) did not apply to a tax year of a foreign corporation beginning after 31 December 2001, then Section 953(a) would be applied as if the tax year of the foreign corporation began in 1998 (i.e., under the law as it existed before the 1998 Changes). The 1998 Changes were extended numerous times until being made permanent in 2015. At no time since the 1998 Changes were adopted were there amendments to the 952(c) election or explicit references in legislative history to the 952(c) election.

IRS analysis

The IRS concludes that the 952(c) election is "a vestige of former law that should have been removed as deadwood, when the final law ([the 1998 Changes]) was made permanent in 2015." The IRS argues that Congress left the 952(c) election unchanged as part of the 1998 Changes (and at each subsequent extension of the 1998 Changes before they became permanent) in case the 1998 Changes expired, in which case the law would revert to that under the Same-Country Exception Era. The IRS argues that there was no reason to repeal the 952(c) election because, had Congress done so and permitted the 1998 Changes to sunset, it would have resulted in the same fundamental character mismatch problems between underwriting and investment activities of an insurance company that the 952(c) election was intended to address.

At the same time, the IRS argues that amending the 952(c) election to update the cross-reference to reflect the 1998 Changes would have been "equally inappropriate" because "the election only needed to be operative when the same-country exception was in effect" and was "no longer necessary" to correct for the type of character mismatch that could occur in the wake of the 1986 Act.

The IRS further argues that the 952(c) election is obsolete by claiming that the legislative history and statutory evolution of the treatment of subpart F insurance income "make clear" that Congress intended the 952(c) election to be available and operative when the same-country election is in force and "unavailable and inoperative" when the 1998 Changes are in force. The IRS cites several cases articulating various theories of statutory construction and concludes that, based on the legislative history of the 952(c) election and lack of an explicit suggestion by Congress that the 952(c) election should continue to be available in the Current AFE Regime, the 952(c) election has been constructively repealed. The IRS cites no precedent that directly supports its conclusion that an election specifically provided via express language still contained in the Code may be treated as repealed.

Implications

The IRS's arguments for finding the 952(c) election obsolete appear to be unsupported in legislative history or other authorities. They also do not address other equally or more valid arguments for finding that the 952(c) election remains available.

First, there is no support in the legislative history for the IRS's assertion that Congress intentionally left the 952(c) election unchanged as part of the 1998 Changes so that it would be available to taxpayers if the 1998 Changes were to expire. Other plausible explanations exist for the 952(c) election to remain unchanged. For example, Congress may have intended to preserve the 952(c) election and update the cross-reference to Section 953(a)(1)(A) in the 952(c)

election but neglected to do so. Alternatively, Congress may have simply not considered the 952(c) election. In the absence of clear legislative history as to why Congress left the 952(c) election unchanged, the question remains whether the 952(c) election is in fact still available.

Second, the IRS asserts that Congress did not intend for the 952(c) election to be available in the Current AFE Regime because it is unnecessary in light of Section 954(i). The IRS's view apparently is that Section 954(i) eliminates the character mismatch problems between underwriting and investment activities that were a basis of the 952(c) election and that Congress intended for the 952(c) election to only apply during the Same-Country Era. The IRS appears to implicitly marry the availability of the 952(c) election with the effective date provision of Section 953(e)(10). Although the IRS argues that Section 953(e)(10) implies that the same-country exception rules do not apply while the 1998 Changes are in force, subSection (e)(10) says nothing about the 952(c) election or any other IRC provision outside of Section 953(a). Further, numerous reasons remain why the Current AFE Regime fails to prevent the character mismatch problems between underwriting and investment activities that the 952(c) election was intended to address, some of which are specifically caused by the Current AFE Regime.

The GLAM provides an example in which an insurance company CFC may be required by a local regulator to form a separate legal entity to hold its investment assets. The investment income held by a subsidiary would typically be subpart F income, which would give rise to character mismatch under the deficit rules if the underwriting income earned by the parent CFC were exempt from subpart F under Section 953(e). The 952(c) election would eliminate the character mismatch through an affiliated group rule that permits the election to apply when the affiliate (e.g., the investment subsidiary) would not qualify as an insurance company on its own but would be a qualified insurance company based on the combined activity of the same-country affiliated group. The IRS asserts that a check-the-box election could be made to treat the investment subsidiary as disregarded, eliminating the need for the 952(c) election. However, there may be regulatory restrictions or other reasons why an insurance company CFC would not be able to elect to treat its investment subsidiary as disregarded. For this reason, the mere presence of the check-the-box regulations would not appear to be supportive of the notion that Congress intended for the 952(c) election to be repealed or that the 952(c) election has been constructively repealed.

Third, the IRS appears to believe that the 952(c) election is constructively repealed because the IRS maintains that the 952(c) election cannot be reconciled to co-exist with the Current AFE Regime, and the Current AFE Regime is clearly a substitute for the rules of the Same-Country Era and the 952(c) election. However, the 952(c) election can easily be reconciled to co-exist with the Current AFE Regime because the Current AFE Regime continues to present character mismatch issues to insurance company CFCs.

Fourth, the IRS argues that, because the legislative history did not explicitly state that Congress intended for the 952(c) election to remain in effect after the 1998 Changes, there should be no "implied amendment" of the 952(c) election to keep it operative (i.e., by fixing the cross-reference to former Section 953(a)(1)(A)). The IRS fails to address other, arguably more relevant principles of statutory construction that conflict with its arguments and would support the 952(c) election remaining available.

Finally, five other IRC sections cross-referenced former Section 953(a)(1)(A) when the 1998 Changes were enacted. None of the other cross-references to Section 953(a)(1)(A) were amended by Congress until 2018, when two were updated to reflect the current Section 953. The IRS fails to address the other cross-references and associated legislative history to understand, by analogy, how the 952(c) election should be viewed as being affected.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. For a US shareholder of a CFC that is a qualified insurance company (as defined in Section 952(c)(1)(B)(v)), Section 952(c)(1)(B)(vii)(I) provides "[a]n election may be made under this clause to have section 953(a) applied for purposes of this title without regard to the same country exception under paragraph (1)(A) thereof. Such election, once made, may be revoked only with the consent of the Secretary."
3. Generally, GILTI would not include gross income of a CFC that is taken into account in determining subpart F income. See Section 951(c)(2)(A)(i)(II).

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