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Memorandum

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to: Deputy Division Counsel
(International)

from: Associate Chief Counsel
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subject: Availability of section 952(c)(1)(B)(vii)(I) Election for Insurance Income

This memorandum sets forth the legal analysis for determining the availability of the election to include insurance income in subpart F income set forth in Internal Revenue Code section 952(c)(1)(B)(vii)(I) (the "952(c) election"). This advice may not be used or cited as precedent.

ISSUE

Whether the 952(c) election for insurance income is obsolete.

CONCLUSION

The 952(c) election has been inoperable since 1998. The 952(c) election was predicated on pre-1998 section 953(a)(1)(A) (the "same country exception"). The same country exception was an integral part of the old subpart F insurance scheme enacted in 1986. The policies, purposes, and mechanics of the same country exception were superseded by the "active financing exception" in sections 953(e) and 954(i) ("AFE") in 1998, which concurrently repealed the same country exception and was made permanent in 2015. The 952(c) election fell away with it.

FACTS

By its terms, the 952(c) election applies to insurance income that would have been excluded from subpart F under the same country exception under pre-1998 section 953(a)(1)(A). The same country exception was repealed on a temporary basis effective for taxable years of foreign corporations beginning after December 31, 1998 and on a permanent basis effective for taxable years of foreign corporations beginning after December 31, 2014. 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 section 951A. It has been posited that the election's cross-reference to the same country exception in pre-1998 section 953(a)(1)(A) should be re-interpreted and replaced with the exempt insurance income exception in section 953(e) ("AFE exempt insurance income").

LAW AND ANALYSIS

I. STATUTORY HISTORY

The subpart F rules that apply to insurance companies can be divided into three distinct eras, each marked by significant shifts in legislative purpose and correspondingly significant differences in applicable rules. The 952(c) election was enacted during the second era in 1988 as part of a larger package of follow-on legislation to the Tax Reform Act of 1986 ("1986 Act") when the same country exception was first enacted. The current version of AFE was enacted 10 years later in 1998 as a temporary provision that was extended 8 times over 17 years and then made permanent in 2015. The statutory structure of each era and the histories described below show that the 952(c) election was a creature of the same country exception rules that became defunct after AFE was made permanent.

A. Subpart F Insurance Rules Before the Same Country Era

Before the same country exception was enacted in 1986, an insurance controlled foreign corporation ("CFC") included, as a separate category of income under section 953, insurance income arising from U.S. risks.¹ An insurance CFC's investment income was generally excluded from the separate subpart F income category of foreign personal holding company ("FPHCI") under section 954 via a broad active financing exception under former section 954(c)(4)(B) and (C). Subject to a cap on current earnings and profits ("e&p"), subpart F income could be reduced by current year deficits ("current year e&p limitation"), accumulated deficits ("accumulated deficit rule"), and current year deficits of other CFCs within the CFC's same chain of ownership ("chain deficit rule").

¹ H.R. Report No. 2518, 87th Cong. 2d Sess., 464-465 (1962), reprinted in 1962-2 C.B. 464-465.

B. Same Country Exception Era

In 1986, Congress amended all three components of the prior subpart F rules (insurance income subject to subpart F, investment income excluded from FPHCI, and the applicable e&p limitations) because of increasing 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. Currently includible subpart F insurance income was expanded to include all insurance income (meaning underwriting and related investment income) other than amounts that arose from insuring risks in the same country as a CFC's place of incorporation (*i.e.*, the same country exception).² At the same time, Congress also repealed the active financing exception to FPHCI.³

Congress believed that the prior deficit rules were overly generous because there was no qualification on whether the losses arose from the same type of activity that generated the subpart F income and the rules incentivized loss trafficking.⁴ Congress addressed the issue by prohibiting prior year non-subpart F losses from offsetting subpart F income and requiring the recapture of current year non-subpart F deficits that limited a subpart F inclusion.⁵ Congress restricted the accumulated deficit rule to a "qualified deficit" that arose from the same "qualified activity" (which, in the case of an insurance CFC, meant subpart F insurance income or FPHCI), among other requirements.⁶ The chain deficit rule was eliminated in 1986 and then re-enacted in 1988 but subject to the "qualified activity" restriction (and other requirements) that were

² Section 953(a)(1)(A) provided: (a) For purposes of section 952(a)(1), the term 'insurance income' means any income which – (1) is attributable to the issuing (or reinsuring) of any insurance or annuity contract – (A) in connection with property in, liability arising out of activity in, or in connection with the lives or health of residents of, a country other than the country under the laws of which the [CFC] is created or organized...."

³ H. R. Report No. 426, 99th Cong. 1st Sess., 393 and 398-399 (1985), reprinted in 1986-3 Vol. 2 C.B 393 and 398-399.

⁴ "Under the chain deficit rule of Code section 952(d). . . , a loss incurred anywhere in a chain of controlled foreign corporations eliminates US tax on an equal amount of income earned elsewhere in the chain even though the loss may be in a nonsubpart F income category or bear little or no relation to the income it offsets. . . . Similarly, the accumulated deficit rule of section 952(c) presently allows a controlled foreign corporation to avoid tax on subpart F income by offsetting that income with prior year deficits it incurred in nonsubpart F or unrelated income categories." H.R. Conf. Rep. No. 841, 99th Cong. 2d Sess., II-623 (1986), reprinted in, 1986-3 Vol. 4 C.B. 623.

⁵ Section 952(c)(1) and (2).

⁶ Section 952(c)(1)(B)(iii). FPHCI was added as a qualified activity in 1988 in the Technical and Miscellaneous Revenue Act.

added to the accumulated deficit rule in 1986.⁷ Thus, deficits from non-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 arose 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). Exacerbating the mismatch were changes made to the deficit rules. The problem the new rules (and specifically the mismatched treatment of same country underwriting and investment income) presented for the insurance industry was that because the insurance business is often cyclical and underwriting losses may span multiple tax years, an insurance CFC with underwriting losses that were clearly related to subpart F investment income inclusions were systematically disallowed. Specifically, the current year e&p limitation rule provided limited relief because it provided only temporary timing relief (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.

The 952(c) election was enacted in 1988 to permit insurance CFCs greater access to the new deficit rules. It did so by allowing them to elect to treat same country insurance income as subpart F insurance income so that same country underwriting losses could be netted against related same country investment income. The election provided that "an 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."⁸

The legislative history to the 952(c) election contains the following statement:

The Senate amendment provides an election to controlled foreign corporations to treat same-country insurance income as subpart F income so long as all related, controlled foreign corporations organized in the same country elect (*thus making same-country insurance income eligible for reduction under the deficit rules of subpart F*) and for purposes of determining whether investment income is derived from

⁷ Section 952(c)(1)(C).

⁸ Section 952(c)(1)(B)(vii)(I). These words have not been deleted from the Code, which gives rise to the issue addressed herein. There are certain other instances in which provisions affected by the enactment of section 953(e) were not originally revised or deleted (including two cross-references changed in 2018).

qualified activities, treats electing corporations as one corporation.

(emphasis added.) H.R. Conf. Rep. No. 1104, 100th Cong. 2d Sess., 195 (1988), reprinted in 1988-3 C.B. 685.

Without the election, a taxpayer might earn little or no insurance income from a business but still be required to include all of its investment income as subpart F income under section 954(c) as FPHCI. For example, consider an insurance CFC with only same country risk and historic NOLs from underwriting losses. The NOLs could not give rise to a qualified deficit to offset future investment income even if it clearly related to the same insurance risks. The 952(c) election permitted same country underwriting losses to be treated as subpart F income and thereby offset the related subpart F investment income.⁹

C. Current AFE Regime (Post Same Country Era)

When Congress again overhauled the rules that applied to insurance CFCs in 1998, the mismatch of underwriting income and related investment income, which prompted the enactment of the election, was addressed by changes to 954(i). The result was that the 952(c) election was no longer necessary to correct for the type of mismatch that could occur under the 1986 Act. Under the new AFE regime, section 954(i) was added to the FPHCI rules; investment income on exempt contracts plus a certain amount of surplus investment income was no longer subpart F income.¹⁰ Thus, investment income from insurance contracts that was exempt under section 953's

⁹ In addition, the 952(c) election also permitted the use of losses in a situation where investment assets were held in an investment subsidiary (typically for benefits under local law). The election accomplished this through an affiliated group rule that permitted the election to apply when the affiliate (here, the investment subsidiary) would not qualify as an insurance business on its own but would be a qualified insurance company if tested based on the combined activity of the same country affiliated group. That fact pattern would have been more salient in 1988 when the election was enacted. In contrast, after the issuance of the check-the-box rules in 1996, the need for the affiliated group rule became less relevant because the investment subsidiary can be treated as a disregarded entity. See T.D. 8697, 61 Fed. Reg. 66584 (Dec. 18, 1996). (Note that an investment subsidiary would not be subject to the per se corporation rules of an insurance company, and a check-the-box election to be treated as a disregarded entity generally would be available. See Treas. Reg. section 301.7701-2(b)(4) and -3.)

¹⁰ Section 954(i)(2). Excess surplus was not excepted because it is analogous to a non-insurance CFC investing excess cash in passive assets abroad. Investment income on reserves and an additional capital cushion for solvency (*i.e.*, amounts necessary for the ongoing business of the insurance company) was excepted. Section 954(i)(2). The legislative history specifically states that "in no event does the exception from FPHCI apply to investment income with respect to excess surplus." H.R. Conf. Rep. 825, 105th Cong. 2d Sess., 1571 (1998), reprinted in 1998-4 C.B. 492.

definition of insurance income was not swept back into subpart F as FPHCI as it had been when the same country exception applied.

The 952(c) election was nevertheless retained in the Code because AFE as originally enacted was only temporary and, if it lapsed, the same country exception (along with its mismatches) would again take effect.¹¹ Congress understood that certain provisions that were creatures of the same country exception would be applicable or not depending on whether AFE was in effect or the same country rules were in effect.

As part of the 1999 extender, Congress added a sentence to section 953(e)(10), which turned a simple sunset provision into a rule providing to what extent the same country exception would apply after the 1998 enactment of AFE. The additional sentence provided that: "If this subsection [953(e)] does not apply to a taxable year of a foreign corporation beginning after December 31, 2001 (and taxable years of United States shareholders ending with or within such taxable year), then, notwithstanding the preceding sentence, subsection (a) shall be applied to such taxable years in the same manner as it would if the taxable year of the foreign corporation began in 1998."

The 1999 Bluebook described the reasons for the technical amendment as follows: "The Congress clarified that if the temporary exception from subpart F insurance income does not apply for a taxable year beginning after December 31, 2001, section 953(a) is to be applied to such taxable year in the same manner as it would for a taxable year beginning in 1998 (i.e., under the law in effect before amendments to section 953(a) were made in 1998). *Thus, for future periods in which the temporary exception relating to insurance income is not in effect, the same-country exception from subpart F insurance income applies as under prior law.*" Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 106th Congress," 18, reprinted in 1999-3 C.B. 349 (emphasis added). Expressed inversely, if AFE is in effect, the same country exception rules do not apply. This was the situation for the many years AFE was extended and, since 2015, made permanent.

The 1999 amendment indicates that Congress specifically contemplated how the same country exception should continue to apply alongside AFE. Leaving the cross-reference to the same country exception in the 952(c) election allowed the prior regime to remain fully intact if AFE expired (which occurred a number of times because of delays to the extender bills, which in each case reinstated AFE retroactively). The election merely lapsed permanently in 2015 when AFE was made permanent.

¹¹ At the time of the 1998 legislation, sections 953(e) (which changed the definition of insurance income) and 954(i) (which changed amounts includible as FPHCI for insurance investment income) were initially one year provisions that, if not extended, would revert back to pre-AFE law. AFE was extended a few years at a time in 1999, 2002, 2006, 2008, 2010, 2013, and 2014, before it was made permanent in 2015.

II. STATUTORY CONSTRUCTION

A. Unambiguous Statute—the Plain Meaning Rule

The first rule of statutory construction is to look to the plain meaning of the statute. “Courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: ‘judicial inquiry is complete.’” Connecticut Nat’l Bank v. Germain, 503 U.S. 249, 254 (1992). “In the usual case, if ‘the statute’s language is plain, the sole function of the courts is to enforce it according to its terms.’” Owner-Operator Indep. Drivers Ass’n v. United States, 556 F.3d 690 (8th Cir. 2008) (citing United States v. Ron Pair Enter., Inc., 489 U.S. 235, 241 (1989)).

A drafting mistake does not obfuscate a provision’s plain meaning if the statute is otherwise clear and is consistent with its legislative history. The portion that is clearly at odds with the statutory scheme can be ignored and is treated as surplusage. Lamie v. United States Trustee, 540 U.S. 526, 536 (2004); Chickasaw Nation v. United States, 534 U.S. 84 (2001). For example, in Chickasaw, the Court held that Congress’s failure to delete an inappropriate cross-reference in the bill that Congress later enacted into law was tantamount to a drafting mistake (and did not create an ambiguity). Id. The Court concluded that it did not view such a drafting mistake as creating an ambiguity (*i.e.*, capable of being understood in two or more possible senses or ways). Rather, it was a non sequitur that should be ignored. Id.

In the present case, the 952(c) election served the purpose indicated in the legislative history. While AFE was still a temporary provision in 1999, Congress specifically stated that the same country exception would have a continuing role and would apply as it did under prior law if AFE were to sunset. Therefore, there was no reason to repeal or amend the 952(c) election at that time. In fact, repealing it would have meant that the election was no longer available if AFE were to sunset and the same country exception came back into force (in which case, the potential mismatches under the pre-AFE subpart F regime would be problematic again). At the same time, an amendment adding a cross-reference to the new AFE exempt insurance provision would have been equally inappropriate because the election only needed to be operative when the same country exception was in effect. Therefore, leaving the 952(c) election unamended in the Code provided the reasonable result that it would be available and operative when the same country exception was in force and would be unavailable and inoperative when AFE was in force.

The 952(c) election became a vestige of former law that should have been removed as deadwood, when the final law (the AFE provision) was made permanent in 2015. At that point, the 952(c) election lapsed into obsolescence and became “surplusage” in the Code. See Chickasaw, at 89 and 92 (“Nor can one give the [cross-reference independent operative effect without seriously rewriting the language of the rest of the statute. . . . It is far easier to believe that the drafters . . . unintentionally failed

to remove what had become a superfluous numerical cross-reference.”). Recognizing the election as obsolete rather than impliedly extended is consistent with the longstanding approach of the courts to such situations. See, e.g., Iselin v. United States, 270 U.S. 245, 250 (1926) (where a statutory scheme is “evidently drawn with care,” “[t]he particularization and detail ... preclude an extension of any provision by implication to any other subject.”).

B. Ambiguous Statute

It is our view that the 952(c) election is unambiguous. Even if one were to take the opposite view, however, and determine that the 952(c) election’s cross-reference to a non-existent provision (the same country exception in section 953(a)(1)(A)) creates an ambiguity, the 952(c) election would still be obsolete.

Canons of statutory construction are intended to effectuate legislative intent, not usurp it. In ascertaining the correct construction of taxing statutes, “it is necessary to read them in the light of the closely related [revenue provisions].” Estate of Sanford v. Comm’r, 308 U.S. 39, 43 (1939). “[T]he meaning of statutory language, plain or not, depends on context.” King v. St. Vincent’s Hosp., 502 U.S. 215, 221 (1991). And “[c]lear evidence of legislative intent prevails over other principles of statutory construction.” Neptune Mut. Ass’n, Ltd. v. United States, 862 F.2d 1546, 1549 (Fed. Cir. 1988).

Here, 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 exception was in force and unavailable and inoperative when AFE was in force. In addition, the following specific rules of statutory construction that apply to resolve an ambiguity also support our conclusion.

In cases where a statute cross-referenced another statute and that latter statute was amended, the Court has held that the statute of specific reference incorporates provisions as they existed at the time of adoption, *without* subsequent amendments, unless a legislature has expressly or by strong implication shown otherwise. See Kendall v. United States, 37 U.S. 524, 625 (1838); Hassett v. Welch, 303 U.S. 303, 314 (1938); see also United States v. Bankoff, 613 F.3d 358 (3d Cir. 2010).

The AFE provisions also did not impliedly amend the 952(c) election. There is a strong presumption that amendments by implication are not favored. “Congress’ employment of amendatory language stops, as it were, at the doorstep of [the referring] section. . . . This omission is of pivotal interpretive significance; for regardless of any functional ‘enmeshment’ of the two statutes, it is well settled that amendments by implication (like repeals by implication) are disfavored. This is a basic premise of our representative democracy; legislatures, not courts, amend and repeal statutes.” Natural Resources Defense Council, Inc. v. Hodel, 865 F.2d 288, 318 (1988).

Therefore, an election in respect of one provision cannot be transported to a different provision absent an express statement of intent to do so. In accordance with the Court's pronouncement in Kendall and Hassett and the doctrine against implied amendments, the 952(c) election should not be re-interpreted to be applicable for purposes of section 953(e). Nowhere do the legislative histories to the same country exception, AFE, or the 952(c) election suggest that Congress intended the 952(c) election be available with respect to the AFE exempt insurance income scheme. In fact, the legislative histories provide the opposite and, as already described, there were multiple good reasons for not amending it.

The doctrine of implied repeal also supports the conclusion that the 952(c) election is inoperative. While implied repeals are not favored, the Court has articulated two well-settled exceptions to this general rule: "(1) where provisions in two acts are in irreconcilable conflict, the later act, to the extent of the conflict, constitutes an implied repeal of the earlier one; and (2) if the later act covers the whole subject of the earlier one and is clearly intended as a substitute, it will operate similarly as a repeal of the earlier act." Posadas v. National City Bank, 296 U.S. 497, 503 (1936). See also Petri v. F.E. Creelman Lumber Co., 199 U.S. 487, 497 (1905); Radzanower v. Touche Ross & Co., 426 U.S. 148, 154 (1976). This is the case even if the subsequent enactment contains no repealing clause. Henrietta Mining & Milling Co. v. Gardner, 173 U.S. 123, 128 (1899); Steamboat Co. v. Collector, 85 U.S. 478 (1873). See also Chase v. United States, 256 U.S. 1, 9 (1921) (holding that where an act covers so completely the subject matter, it must be held to repeal that portion of the prior act even though the later act contained no repealing words). "Laws are in irreconcilable conflict where they cannot mutually co-exist." Radzanower at 155; Neptune at 1551. Here, Congress made clear that the same country exception was not to co-exist with the AFE provisions and hence, to the extent that repeal was not explicit (as with respect to section 952(c)(1)(B)(vii)(I)), it would be implied.

"Congress will specifically address pre-existing law when it wishes to suspend its normal operations in a later statute." Epic Systems Corp. v. Lewis, 138 S. Ct. 1612, 1624 (2018). It did so here in the 1999 technical amendment to AFE -- the 952(c) election would be operative only in years for which the same country exception was operative. When AFE became permanent in 2015, the 952(c) election became deadwood, and as described above, the election has been functionally obsolete since 1998 when AFE was enacted and permanently ceased to exist in 2015.

cc: Field Counsel