Treatment of Insurance Companies under Dual Consolidated Loss Regulations

Recently issued final regulations that provide guidance on dual consolidated losses (DCLs) clarify the rules for insurance companies that make Section 953(d) elections, but they also raise new concerns about the treatment of "domesticated" insurance companies.

Section 953(d) Elections

Under Section 953(d), a controlled foreign corporation (CFC) engaged in the insurance business may elect to be treated as a U.S. corporation for U.S. federal tax purposes. Making the election allows a company to avoid the complexities of complying with the Subpart F rules and prevents the company from being subject to the branch profits tax, the federal excise tax on insurance premiums received, and the withholding tax on any earned U.S.-sourced investment income. A foreign company that makes a Section 953(d) election is subject to U.S. federal income tax on its worldwide income and must determine the tax due as if it was a domestic corporation subject to part I or part II of subchapter L (i.e., a life insurance company or a property and casualty insurance company). The electing corporation must timely file the U.S. tax return that is due when the election becomes effective and must timely pay any U.S. taxes due, including estimated payments. In addition, an electing foreign life insurance company that is not subject to State insurance regulations may face several technical issues with respect to its reserves.

A foreign corporation may make a Section 953(d) election for taxable years beginning after December 31, 1987. The election requires that a corporation:

- Qualify as a CFC (as defined under Section 953(c)(1)(A), applying a 25 percent or more test)
- Would qualify under part I or II of subchapter L if the corporation was a domestic corporation
- Meet certain U.S. Treasury requirements to ensure that the corporation will pay its taxes
- Waive all benefits granted by the United States under any treaty between the U.S. and any foreign country

An electing foreign corporation also must meet certain administrative requirements. A Section 953(d) election is effective on the first day of the first taxable year (including a short taxable year) for which five procedural requirements are met:

- An election statement is filed in accordance with Rev. Proc. 2003-47
- A U.S. shareholder list is attached
- The corporation executes Form 2848 or Form 8821 to designate a U.S. resident as its authorized representative to receive confidential tax information
- The corporation agrees to produce its books and records, or a true and accurate copy thereof, in the United States upon request of the IRS
- A closing agreement is provided, unless the office test and asset test described in Rev. Proc. 2003-47 are met

Consolidated Groups

A corporation that makes a Section 953(d) election may join in the filing of a consolidated return. Generally, an electing corporation that satisfies the stock ownership requirements of Section 1504(a) will become an includible corporation in an affiliated group when it is first treated as a domestic corporation under Section 953(d).

For an electing corporation that joins a consolidated group, any loss incurred by that corporation must be treated as a DCL under Section 1503(d), without regard to any of the exceptions provided under the Section 1503(d)(2)(B) regulations. Such a loss appears to be treated as a DCL without regard to the definition of a DCL under Section 1503(d)(2)(A). For these purposes, loss means net operating loss as defined under Section 172(c), but does not include a capital loss, as defined under Section 1222.

In the Tax Reform Act of 1986, Section 953(d)(3) provided that any loss incurred by the electing corporation would be treated as a DCL, without regard to any regulatory exception under Section 1503(d)(2)(B). However, the Omnibus Budget Reconciliation Act of 1989 attempted to further clarify that the DCL treatment was a per se rule. Specifically, the 1989 House Report (H.R. Rep. No. 247, 101 Cong., 1st Sess. 1419 [1989]) stated:

> The Treasury generally does not have authority to promulgate regulations making the loss of an electing corporation not a dual consolidated loss.
> . . .
> The bill clarifies that any loss of a foreign corporation electing to be treated as a domestic insurance company will be treated as a dual consolidated loss and will therefore not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year. Thus, the bill clarifies that the treatment of electing corporation losses as dual consolidated losses under Section 953(d) precludes any contrary treatment under regulations that may provide exceptions for the definition of dual consolidated losses.

DCL Regulations

Some practitioners have taken the position that a foreign corporation that has made a Section 953(d) election may use its losses against the income of another affiliated group member pursuant to former Reg. Sec. 1.1503-2(g) (current Reg. Sec. 1.1503-6(d)). These rules provided an exception to the general treatment of DCLs if the taxpayer entered into an agreement with the IRS to use the DCL only for U.S. federal income tax purposes. Practitioners argued that these losses never ceased to be DCLs — they simply were permitted to offset the income of other affiliated group members and were subject to recapture and DCL treatment if the requirements of the election were not met in the future. In FSA 200024021, the IRS rejected this argument, stating that an election under former Reg. Sec. 1.1503-2(g) could not be made with regard to the losses of an insurance company that had made a Section 953(d) election. In May 2005, the IRS issued proposed regulations under Section 1503(d) that affirmed the unconditional application of the DCL rules to a Section 953(d) company.

This position is reflected again in the current final regulations under Section 1503(d), which were issued in March 2007. The 2007 final regulations also make it clear that Section 1503(d) applies to the separate units of a Section 953(d) company and to any losses that carry over to a domestic corporation from a Section 953(d) company in a Section 381 transaction. Further, a Section 953(d) company's losses or income may not

be aggregated with the income or losses of another affiliated Section 953(d) company organized in the same country. The 2007 final regulations generally are effective for taxable years beginning after April 18, 2007.

Domesticated Insurance Companies

The preamble to the 2007 final Section 1503(d) regulations contemplates extending by regulations (potentially retroactively) the application of Section 953(d)(3)-like rules to domesticated insurance companies that, otherwise, would have been eligible to make Section 953(d) elections as foreign insurance companies.

These regulations could provide that if a foreign insurance company is eligible to make an election to be treated as a domestic corporation pursuant to Section 953(d), but, in lieu of making such election, becomes a domestic corporation through other means (e.g., by filing a certificate of domestication in a State as a limited liability company), then such company would be subject to the limitations under Sections 953(d)(3) and 1503(d) (without regard to paragraph (2)(B) thereof).

Expansion of the application of a Section 953(d)(3)-like treatment to domestic corporations with foreign insurance operations is troubling because the guiding policy and scope of these future regulations are unclear. The preamble to the final regulations states that a domesticated insurance company that otherwise could have made a Section 953(d) election should be subject to limitations similar to those provided under Section 953(d)(3).However, it is not clear that Section 953(d)(3) was intended to require, without exception, that under Section 1503(d), other domesticated corporations with foreign insurance operations be subject to the limitations under Section 1503(d) and for their losses to be treated per se as DCLs. The cross-reference in Section 953(d)(3) to Section 1503(d) may have been only a means to provide a segregated treatment to a Section 953(d) company's net operating losses.

Other domestication regimes achieve a similar segregated treatment to net operating losses through other means. For example, a stapled foreign corporation that is treated as a domestic corporation under Section 269B is not an includible corporation under Section 1504. It is unclear why future regulations would be limited to domesticated corporations and could not be expanded further to include corporations with foreign insurance operations that always have been organized as domestic corporations. Overall, application of Section 953(d)(3)-like rules to domestic corporations with foreign insurance operations appears to target insurance companies with foreign operations in a manner not applied under Section 1503(d) to other industries or justified by the legislative history to Section 953(d)(3) or Section 1503(d).

Applicability of DCL Rules

The U.S. Treasury has the authority to limit any exceptions available to a corporation with a DCL under Section 1503(d)(2)(B). However, non-Section 953(d) domesticated or domestic insurance companies must determine whether their losses are DCLs under Section 1503(d)(2)(A) because the per se rule of Section 953(d)(3) does not apply. Applying a per se DCL treatment to these domesticated or domestic insurance companies may exceed Treasury's authority under Section 1503(d)(2)(A). In this section a DCL is defined to mean any net operating loss of a domestic corporation subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of the foreign country, or is subject to such a tax on a residence basis.

Section 1503(d)(2)(A) grants Treasury no authority to expand this definition of a DCL, but exceptions may be provided under Section 1503(d)(2)(B).

Arguably, a domestic insurance company engaged in an insurance business in a foreign jurisdiction that does not impose any income tax, such as Bermuda, would not appear to be a dual resident corporation under the final regulations, and its net operating loss should not be a DCL under the statute. Any contrary result in future regulations may require a legislative grant of authority.

Nevertheless, under the final regulations, such foreign operations may be viewed as a separate unit of the domestic insurance company to the extent it constitutes a foreign branch as defined in Reg. Sec. 1.367(a)-6T(g)(1) and its net operating losses are treated as a DCL under the final regulations, without regard to the definition of a DCL under Section 1503(d)(2)(A). This treatment is mitigated by the availability of a separate unit to demonstrate, under Reg. Sec. 1.1503(d)-6(c), that no foreign use of the DCL occurred in the year in which it was incurred, and that no foreign use can occur in any other year by any means. This mechanical approach under the final regulations effectively conforms the net operating losses of a separate unit (operating in a jurisdiction that does not impose any income tax) to the statutory definition of a DCL. However, to the extent that a separate unit of a domesticated or domestic insurance company is not permitted to avail itself of Reg. Sec. 1.1503(d)-6(c), future regulations may exceed the statutory definition of a DCL by including as a DCL the net operating losses of a separate unit that operates in a jurisdiction without an income tax.

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