

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject: Tax Consequences of an Invalid Section 953(d) Election

This Generic Legal Advice Memorandum responds to your request for assistance with regard to the federal income tax consequences of an invalid election under section 953(d) of the Internal Revenue Code (Code). This memorandum may not be used or cited as precedent.

FACTS

A United States shareholder (within the meaning of section 951(b) of the Code) (Taxpayer) owns shares of a controlled foreign corporation (CFC) within the meaning of sections 953(d)(1)(A) and 957(a). In Year 1, CFC purportedly made an election under section 953(d) to be treated as a domestic corporation and an election under section 831(b)(2)(A) to pay an alternative tax provided in section 831(b) based only on its taxable investment income. Taxpayer pays annual amounts designated as “premiums” to CFC in exchange for what is purported to be insurance coverage with respect to business risks of Taxpayer. CFC’s income consists exclusively of “premiums” received from Taxpayer and investment income. Since Year 1, and in accordance with its purported elections under sections 953(d) and 831(b)(2)(A), CFC has filed an annual

Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, and excluded the “premiums” it receives from gross income for U.S. income tax purposes. Consistent with that position, Taxpayer deducted the premiums paid to CFC, did not include under section 951(a) its pro rata share of CFC’s subpart F income, and did not file any Forms 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*. If CFC’s and Taxpayer’s tax reporting were correct, then the normal three-year period of limitations for assessment under section 6501(a) has expired for CFC’s and Taxpayer’s Year 1 taxable years.

During an examination of CFC’s Year 4, the Service concluded that under various arguments, including judicial doctrines, CFC would not qualify under part I or II of subchapter L (*i.e.*, CFC is not an insurance company) if it were a domestic corporation. As a result, CFC is ineligible to make an election under section 953(d), and its election is invalid.

ISSUE(S)

1. What are the federal income tax consequences to CFC and its U.S. shareholders where CFC’s purported election under section 953(d) is determined to be invalid?
2. If CFC’s U.S. shareholders fail to report information required by section 6038, does section 6501(c)(8) apply to extend the limitations period for assessment under section 6501(a)?
3. Are CFC’s U.S. shareholders’ Form 5471 filing obligations satisfied by CFC’s filing of Form 1120-PC?

CONCLUSIONS

1. CFC’s section 953(d) election is invalid because CFC would not qualify under part I or II of subchapter L if it were a domestic corporation. Thus, CFC remains a foreign corporation and is subject to U.S. income tax under section 881 to the extent that it has U.S. source fixed or determinable, annual or periodical income, or under section 882 to the extent that it has income that is effectively connected with a U.S. trade or business.
2. Yes. As described in more detail below, if CFC’s U.S. shareholders fail to report information required by section 6038, then section 6501(c)(8) applies to extend the limitations period for assessment. Specifically, under section 6501(c)(8), the period of limitation for assessment is three years after the date the information is furnished to the Service.
3. No. Section 6038 requires CFC’s U.S. shareholders to provide the information specified on Form 5471 to the Service. For purposes of section

6501, the Form 1120-PC filed by CFC is not considered to be the return of its U.S. shareholders. Further, the information provided on CFC's Form 1120-PC does not substantially comply with the requirements of section 6038 and Form 5471.

LAW AND ANALYSIS

In general, section 953(d) permits a foreign corporation that would qualify as an insurance company under subchapter L of the Code if it were a domestic corporation and that meets certain other requirements, to elect to be treated as a domestic corporation for federal income tax purposes. Notice 89-79, 1989-2 C.B. 392, and Rev. Proc. 2003-47, 2003-2 C.B. 55, provide procedural rules for making the election under section 953(d). A foreign corporation's election under section 953(d) applies for the year in which the election is made and to all subsequent years in which the requirements of Rev. Proc. 2003-47 and section 953(d) are satisfied, unless revoked with the Commissioner's consent or terminated by the Commissioner. If the electing corporation fails to timely file a return, pay the tax due as stated on the return, or comply with any other requirement for making the election contained in Rev. Proc. 2003-47 or section 953(d), the Commissioner, in his discretion, may terminate the election as of the beginning of the taxable year after the taxable year with respect to which the failure occurs. If it is determined that a CFC does not qualify as an insurance company under subchapter L, the CFC will fail to meet the requirements for electing under section 953(d)(1) to be treated as a domestic corporation, and it will be treated as a foreign corporation for federal income tax purposes. Section 953(d)(1)(B).

Section 6038(a)(4) requires any U.S. person who controls a foreign corporation, including U.S. persons who are U.S. shareholders of a foreign corporation that is treated as a CFC, to file a Form 5471 to report the information as prescribed in section 6038(a)(1). Further, section 6038(a)(2) provides that the required information must be furnished for the annual accounting period of the foreign business entity ending with or within the U.S. person's taxable year. The penalty for failure to file a Form 5471 is \$10,000 for each annual accounting period with respect to which such failure occurs and \$10,000 for each 30-day period (or fraction thereof) after the U.S. person has been notified of such failure for more than 90 days. The maximum continuing failure to file penalty is \$50,000. See section 6038(b)(1) and (2).

Generally, the Service has three years from the date a return is filed to assess any tax imposed by Title 26. Section 6501(a). The "return" that starts the three-year limitations period is "the return required to be filed by the taxpayer (and does not include the return of any person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit)."¹ Section 6501(a). However, section 6501(c) provides

¹ There are two "returns" which could be at issue here with respect to CFC's U.S. shareholders. First, with respect to the section 6038(b) penalties for failure to file, the "return required to be filed by the taxpayer" would be the Form 5471. See Treas. Reg. § 1.6038-2. This information return, required under

exceptions that can extend the normal three-year period of limitations for assessment under section 6501(a). In particular, section 6501(c)(8) extends the period of limitation on assessment when a taxpayer fails to report information required under section 6038 until three years from the date the taxpayer provides the required information.

Section 6501(c)(8) was amended as of March 18, 2010. Prior to the March 18, 2010, amendment, section 6501(c)(8) provided, in relevant part, that in the case of any information which was required to be reported to the Secretary under section 6038, the time for assessment of any tax imposed with respect to any "event or period" to which such information related shall not expire before the date which is three years after the date on which the Secretary is furnished the information required to be reported. It was the Service's position that section 6501(c)(8), prior to the 2010 amendment, only extended the assessment period with respect to the tax consequences related to the information required to be reported under the relevant reporting section. See, e.g., the preamble to TD 8850 (final regulations under section 6038). Accordingly, section 6501(c)(8) did not extend the period of limitations for assessment to *all* items on a taxpayer's return for the year at issue.

Following the amendment, section 6501(c)(8) provides, in relevant part, that in the case of any information which is required to be reported to the Secretary under section 6038, the time for assessment of any tax imposed with respect to any "tax return, event or period" to which such information relates shall not expire before the date which is three years after the date on which the Secretary is furnished the information required to be reported. The amendment applies to returns filed after March 18, 2010, or returns filed on or before that date if the section 6501 period (determined without regard to such amendments) for assessment of such taxes had not expired as of that date. See §§ 513(c) and (d) of the Hiring Incentives to Restore Employment (HIRE) Act, Pub. L. No. 111-147, 124 Stat. 112 (2010). The inclusion of "tax return" in section 6501(c)(8) means the extended period applies to the taxpayer's entire tax return and is not limited to adjustments to income related to the information that should have been reported under section 6038.² See Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The HIRE Act, Under Consideration in the Senate, JCX-4-10 (February 23, 2010).

section 6038 and Treas. Reg. § 1.6038-2, is the "return" for purposes of determining the section 6501(a) assessment period of limitations for section 6038(b) penalties. Therefore, the assessment period of limitations with respect to such penalties will not expire until three years after the filing of the relevant Form 5471. Second, Form 1040 is the income tax return of the U.S. shareholders. In this instance, the return for assessment purposes would be the Forms 1040 filed by each of the U.S. shareholder. The assessment period of limitations with respect to the U.S. shareholders' Forms 1040 are determined by the relevant application of section 6501(c)(8) discussed throughout this memorandum.

² While it seems unlikely to be relevant on the facts presented, it should be noted that even under the amended version of section 6501(c)(8), the extension of the limitations period for assessment can still be limited to related items, as opposed to the entire return, if the failure to file the Form 5471 is due to reasonable cause, and not willful neglect. Section 6501(c)(8)(B).

In this situation, CFC would not qualify under various arguments, including judicial doctrines, under part I or II of subchapter L if it were a domestic corporation. Thus, CFC's section 953(d) election is invalid, and CFC remains a controlled foreign corporation and is subject to U.S. income tax under section 881 to the extent that it has U.S. source fixed or determinable, annual or periodical income or under section 882 to the extent that it has income that is effectively connected with a U.S. trade or business.

In addition, because CFC is a controlled foreign corporation, CFC's U.S. shareholders, including Taxpayer, must include in gross income their pro rata share of CFC's subpart F income, if any, under section 951(a). Under section 6038(a)(4), CFC's U.S. shareholders, including Taxpayer, must also furnish a Form 5471 reporting the information required by section 6038(a)(1) with respect to their ownership in CFC for all taxable years that it is a controlled foreign corporation.

Taxpayer has not filed any Forms 5471 for Years 1 through 4. The penalty for failure to file a Form 5471 is \$10,000 for each annual accounting period with respect to which such failure occurs. Section 6038(b)(1). If the failure continues more than 90 days after the taxpayer is notified by the Service, there is an additional penalty of \$10,000 for each 30-day period (or fraction thereof), beginning after the 90th day after the notice is mailed. Section 6038(b)(2). The maximum penalty for the continuing failure to file is \$50,000 for each failure. Section 6038(b)(2).

With respect to CFC's U.S. shareholders, including Taxpayer, section 6501(c)(8) extends the normal three-year period of limitations for assessment on each U.S. shareholder until three years after the date that the U.S. shareholder files the relevant Form 5471. With respect to tax returns filed by CFC's U.S. shareholders after March 18, 2010, or returns of CFC's U.S. shareholders filed on or before March 18, 2010 if the assessment period of limitations was still open on that date, section 6501(c)(8) extends the period of limitation with respect to entire return until three years after the date that the U.S. shareholder files the relevant Form 5471. For returns filed by CFC's U.S. shareholders on or before March 18, 2010, where the period of limitations on assessment had expired by March 18, 2010, the extended period of limitations under section 6501(c)(8) still applies, but is limited to the assessment of tax related to the unreported information which was required under section 6038.

Lastly, section 6038 requires CFC's U.S. shareholders to provide the information specified on Form 5471 to the Service. For purposes of section 6501, the Form 1120-PC filed by CFC is not considered to be the return of its U.S. shareholders. Further, the information provided on CFC's Form 1120-PC does not substantially comply with the requirements of section 6038 and Form 5471.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Kate Hwa at (202) 317-6934 if you have any further questions.