

Office of Chief Counsel
Internal Revenue Service
memorandum

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GSoba

date: November 20, 1996

to: Assistant Commissioner (International)
Attention: Barrett Wanamaker, Case Manager, Group 1110
CP:IN:D:EX:HQ:111

from: Associate Chief Counsel (International)
Elizabeth U. Karzon, Senior Technical Reviewer *ELU/k*
George Soba, Senior Attorney-Advisor *GS*

subject: [REDACTED]
Section 842(b), MECNII

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You requested our advice regarding the implication of the lack of regulations under section 842(d)(2) on the application of section 842(b).

PMTA: 00121

Facts:

The facts provided to us by you and in a related request from the Philadelphia Appeals Office are as follows. For its [REDACTED] tax years, the taxpayer's minimum effectively connected net investment income ("MECNII") computed under section 842(b) exceeded its claimed actual effectively connected net investment income ("AECNII") by \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED], respectively.¹ For tax years [REDACTED] through [REDACTED] the taxpayer's AECNII exceeded its MECNII by \$ [REDACTED], \$ [REDACTED], and \$ [REDACTED], respectively. For Federal income tax purposes the taxpayer reported its AECNII for each of the tax years [REDACTED] through [REDACTED] based on its view that section 842(b) violates the business profits and non-discrimination provisions, articles VII(2) and XXV(6), of the U.S. - Canada income tax treaty.² On audit, adjustments were made asserting an increase in the taxpayer's income tax to reflect the difference between MECNII and AECNII for tax years [REDACTED]

Law:

Section 842(b) attributes to foreign insurance companies carrying on an insurance business within the United States a minimum amount of net investment income, called "minimum effectively connected net investment income," or "MECNII." It does so by requiring the permanent establishment to report the greater of its MECNII or its actual effectively connected net investment income ("AECNII"). I.R.C. § 842(b)(1).

Section 842(d) provides that the Secretary shall issue regulations necessary or appropriate to carry out the purposes of section 842. Those regulations were to provide, among other things, "for proper adjustments in succeeding taxable years where the company's actual net investment income for any taxable year which is effectively connected with the conduct of an insurance business within the United States exceeds the amount required under subsection (b)(1)...." I.R.C. § 842(d)(2). No regulations have been issued to provide for such an adjustment.

¹ We assume that MECNII was computed without using the 842(b)(4) worldwide yield election.

² The Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980, effective August 16, 1984, 1 Tax Treaties (CCH) ¶ 1903.07, T.I.A.S. No. 11087.

Where a statute provides that its terms shall apply to a type of transaction only if specifically prescribed by regulation, the absence of a regulation applying the statute a particular transaction causes the statute not to apply to that type of transaction. Alexander v. Commissioner, 95 T.C. 467 (1990) (holding that the provisions of section 465 did not apply to activities not specifically defined in the statute where the Secretary failed to issue regulations identifying the activities to be covered as required by the statute). However, where the statute directs the Secretary to issue regulations setting forth how a statute is to be applied, the absence of a regulation applying the statute will not render the provisions of the statute inoperative. Occidental Petroleum Corp. v. Commissioner, 82 T.C. 818 (1984) (holding that the lack of regulations setting forth how the tax benefit rule was to be applied did not preclude the taxpayer from applying the tax benefit rule); H. Enterprises International, Inc. v. Commissioner, 105 T.C. 71 (1995) (finding that the failure of the Secretary to issue regulations under section 7701(f) to prevent the avoidance of provisions linking borrowing to investment through the use of related parties, did not preclude the application of those principles in limiting the dividend received deductions and interest expense deductions in situations involving the use of related entities). Thus, both taxpayers and the Service may apply statutory provisions which direct the Secretary to issue regulations that clarify or describe how the statute is to be applied. However, where the statute directs the Secretary to issue regulations setting forth whether a statute is to be applied, the statutory provisions will not apply to the transaction until the Secretary issues the regulations.

Section 842(d) calls on the Secretary to prescribe regulations "necessary or appropriate to carry out the purposes of" section 842. It includes as one of the purposes to be fostered by regulations the "proper adjustments in succeeding taxable years where the company's ... [AECNII] ... exceeds its ... [MECNII]." I.R.C. § 842(d)(2). The Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987 clarifies that excess AECNII for one year may be carried forward to reduce excess MECNII in a subsequent year. It states:

The conferees anticipate that if the actual effectively connected net investment income of a foreign insurance company for any year exceeds the minimum effectively connected net investment income of such insurance company, then such excess is to reduce the amount of net investment income that would otherwise be imputed to the company under this provision for a later taxable year.

H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 982, 1987-3 C.B. 262. Thus, both the statute and the Conference Report anticipate regulations describing how an adjustment is to be made, not whether the adjustment is to be made. The lack of regulations describing the proper adjustments to be made does not operate to defeat this purpose. Occidental Petroleum Corp. v. Commissioner, 82 T.C. 818 (1984); E. Enterprises International, Inc. v. Commissioner, 105 T.C. 71 (1995). Therefore, appropriate adjustments may be made.

The statute and the Conference Report call for regulations that would reduce MECNII in a later year for the excess of AECNII over MECNII for a prior year. The following examples demonstrates how this could be applied for settlement purposes.

<u>Year</u>	<u>AECNII</u>	<u>MECNII</u>	<u>A>M</u>	<u>M>A</u>	<u>Amount to be Reported</u>
1	\$10	\$ 7	\$ 3		\$10
2	9	13		\$ 4	10
3	9	13		4	13
4	12	7	5		12

In year 1, the taxpayer must report net investment income of \$10, its AECNII. In year 2, the taxpayer would report net investment income of \$10, the \$13 of MECNII reduced by the \$3 by which AECNII exceeded MECNII in year 1. In year 3, the taxpayer would report its MECNII since all of the excess AECNII over MECNII for year 1 was exhausted in year 2. In addition, since neither the statute nor the Committee Report provides any basis for carrying excess AECNII back to an earlier year to reduce the earlier year MECNII, the excess AECNII over MECNII in year 4 can not be used to reduce the excess MECNII over AECNII in year 3. Finally, in year 4, the taxpayer must report net investment income of \$12 since neither the statute nor the Committee Report provide a basis for carrying excess MECNII over AECNII either forward or back to reduce an excess of AECNII over MECNII.

We enclose for your information a copy of brief filed on behalf of the Internal Revenue Service in the North West Life Assurance case which dealt with similar issues to those being raised by this taxpayer.

If you need any further assistance, please call George Soba or Elizabeth Karzon at (202) 622-3860.