INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Team Manager
LMSB NR 1416

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Country X =
State of Y =
Year AA =
Year BB =

ISSUE(S):

Whether Taxpayer is entitled to relief under section 7805(b) of the Internal Revenue Code from the retroactive application of a technical advice memorandum ruling that Taxpayer, a foreign life insurance company carrying on an insurance business in the United States, must determine the amount of income effectively connected with its U.S. business under the standards set forth in section 864(c) and the regulations.

CONCLUSION:

Taxpayer is not entitled to relief under section 7805(b) from the retroactive application of the technical advice memorandum requiring Taxpayer to determine its effectively connected income under the standards set forth in section 864(c) and the regulations.

FACTS:

Taxpayer is a foreign life insurance company and its business consists of issuing life insurance, annuity, and other insurance contracts in Country X and the United States. Taxpayer conducts its U.S. life insurance business through a U.S. branch. The State of Y is the point of entry of the U.S. branch.

The State of Y requires Taxpayer, as a foreign life insurance company, to maintain trusteed assets and deposits in the United States sufficient to satisfy all potential claims of its U.S. policyholders. In general, under State Y law, the trusteed assets must have a value at least equal to a U.S. branch's reserves and other liabilities as well as the minimum capital and surplus required by the state insurance code. The trusteed assets are held exclusively for the benefit and protection of U.S. policyholders.

Taxpayer must file a statement with the State of Y and with the insurance departments of each of the states in which it operates on forms published by the National Association of Insurance Commissioners ("NAIC"). (Hereinafter, the statement filed with state insurance commissioners is referred to as the "NAIC statement.") Generally, the NAIC statement is intended to show whether an insurance company has a sufficient amount of assets to meet all liabilities of its U.S. branch operations. Taxpayer includes trusteed assets and the income earned thereon on the NAIC statement. However, the NAIC statement does not necessarily include all assets used in Taxpayer's U.S. trade or business.

In addition to the trusteed assets, Taxpayer maintains non-trusteed assets in the United States consisting of bonds, stocks, and short-term investments which are managed, maintained, and accounted for in the United States. Non-trusteed assets are not necessarily reflected in the NAIC statement. The field represents that Taxpayer uses non-trusteed assets in its U.S. insurance business.

Taxpayer does not include income derived from its non-trusteed assets on its U.S. federal income tax return as effectively connected income. Taxpayer's position is that income attributable to the non-trusteed assets is not income effectively connected with the conduct of its U.S. insurance business because this income is not required to be included on its NAIC statement.

In Year AA, prior to the enactment of current sections 842 and 864, the Service issued a technical advice memorandum addressing how income earned on Taxpayer's non-trusteed assets ("the AA TAM") should be reported. The AA TAM ruled that income earned on trusteed assets was taxable under section 819(a), the predecessor of section 842, and income earned on non-trusteed assets was taxable under section 882, as part of Taxpayer's U.S. trade or business. Thus, income on both trusteed and non-trusteed assets was subject to U.S. income taxation net of appropriate deductions.

In Year BB, the Service issued a technical advice memorandum ("BB TAM") addressing whether Taxpayer must determine the amount of income which is effectively connected with its U.S. trade or business under the standards set forth in section 864(c). The BB TAM ruled that Taxpayer determines the amount of income which is effectively connected with its U.S. trade or business under the standards set forth in section 864(c) of the Code, not based on whether the income was reflected on the NAIC statement.

Taxpayer has requested relief under section 7805(b) from the retroactive application of

the ruling in the BB TAM.

LAW AND ANALYSIS:

Section 7805(b)(8) provides in relevant part:

> The Secretary may prescribe the extent, if any, to which any ruling...relating to the internal revenue laws shall be applied without retroactive effect.

See also Treas. Reg. 301.7805-1(b).

The Secretary's decision not to accord relief from the retroactive application of a ruling will be sustained, unless it is found to constitute an abuse of discretion. Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957); CWT Farms, Inc. v. Commissioner, 755 F. 2d 790, 802 (11th Cir. 1985), *cert. denied,* 477 U.S. 903 (1986); Baker v. Commissioner, 748 F.2d. 1465, 1467 (11th Cir. 1984), *acq.* 1996-1 I.R.B. 5; First Chicago Corp. v. Commissioner, 96 T.C. 421, 438 (1991), *aff'd.*, 135 F.3d 457 (7th Cir. 1998); Chock Full O' Nuts Corp. v. U.S., 453 F.2d 300, 303, fn 6 (2d Cir. 1971).

Under Revenue Procedure 2001-2, a ruling in a technical advice memorandum which is adverse to a taxpayer is generally applied retroactively, unless the appropriate Associate Chief Counsel with jurisdiction over the case exercises his or her authority under section 7805(b) to limit the retroactive effect of the ruling. Rev. Proc. 2001-2, 2001-2 I.R.B. 104, §17.02.

In general, Rev. Proc. 2001-2, §17.06 sets forth that a ruling will not be given retroactive effect under section 7805(b) in cases where a technical advice memorandum revokes or modifies another technical advice memorandum, provided four conditions are satisfied:

> (1) no misstatement or omission of material facts may exist;
> (2) the facts at the time of the transaction must not be materially different from the facts on which the technical advice memorandum was based;
> (3) the applicable law must not have changed; and
> (4) the taxpayer directly involved in the letter ruling or technical advice memorandum must have acted in good faith in relying on the technical advice memorandum, and the retroactive modification or revocation would be to the taxpayer's detriment.

Rev. Proc. 2001-2, §17.06.

In summary, Rev. Proc. 2001-2, sec. 17.06 states that non-retroactive relief from a ruling in a technical advice memorandum is appropriate when a ruling therein modifies or revokes a ruling in a previously issued technical advice memorandum upon which a taxpayer relied in good faith and retroactive application of the new ruling would be to

the taxpayer's detriment. However, a condition for granting non-retroactive relief under Rev. Proc. 2001-2 is that the applicable law and material facts must not have changed. Even assuming Taxpayer could be viewed to have detrimentally relied upon the AA TAM, section 7805(b) relief is not appropriate in this case under the standards set forth in Rev. Proc. 2001-2 because the applicable law changed.

The Foreign Investors Tax Act of 1966 (Pub. Law 89-809 (1966)) (the "1966 Act"), enacted after the AA TAM was issued, made substantial changes to the laws governing how a foreign corporation with a U.S. trade or business pays U.S. tax. Among other changes, the 1966 Act generally requires a foreign corporation to determine the amount of investment income subject to U.S. tax net of deductions based upon whether the income is "effectively connected" to a U.S. trade or business. See secs. 882, 842, and 864. Because the 1966 Act changed the applicable law upon which the AA TAM was based, it would not be appropriate to grant non-retroactive relief under the standards set forth in Rev. Proc. 2001-2.

Taxpayer states that it is not seeking section 7805(b) relief under the provisions set forth in Rev. Proc. 2001-2, sec. 17.06. Instead, Taxpayer contends that its "reasonable and long-standing understanding" of section 842(a), not a prior technical advice memorandum, is the basis for Taxpayer's section 7805(b) request. In support of its contention, Taxpayer states that section 7805(b) gives the Secretary authority to grant non-retroactive relief when it is necessary to avoid "inequitable results," not just when the standards of the Rev. Proc. 2001-2 are met.

Section 7805(b)(8) gives the Secretary discretion to grant non-retroactive relief from a ruling, and Rev. Proc. 2001-2 sets forth the manner in which that discretion is generally exercised. The Secretary may grant non-retroactive relief when necessary to avoid inequitable results, including circumstances not described in Rev. Proc. 2001-2. See Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957). However, Taxpayer has failed to show non-retroactive relief from the ruling in the BB TAM is appropriate in this case.

Taxpayer claims that section 7805(b) relief is appropriate when a taxpayer takes a reasonable but incorrect position that goes unchallenged for some period of time. Taxpayer also states that because other similarly situated taxpayers may have taken the same position, section 7805(b) relief is appropriate. Taxpayer fails to cite any authority directly supporting its position. Instead, Taxpayer cites a number of published and unpublished rulings in which the Service granted section 7805(b) relief to taxpayers to prevent inequitable results.

Section 7805(b) relief is granted at the discretion of the Secretary to prevent inequitable results but does not simply extend to all cases in which a taxpayer takes a reasonable but erroneous position that goes unchallenged for many years. It is established law that the Service's acceptance of the erroneous treatment of items in prior taxable years does not preclude the correction of the erroneous treatment in succeeding years. See

e.g. Knights of Columbus Counsel v. U.S., 783 F.2d 69 (7th Cir. 1986); Unity Equity Cooperative Exchange v. Commissioner, 481 F.2d 812 (10th Cir. 1973), *cert. denied*, 414 U.S. 1028 (1973); Harrah's Club v. U.S., 228 Ct. Cl. 650 (1981); Hawkins v. Commissioner, 713 F.2d 347 (8th Cir. 1983). We also question whether Taxpayer's position was reasonable whether or not other taxpayers may have taken the same position.

Taxpayer's position that NAIC statements are determinative of the amount of effectively connected income of a foreign life insurance company is not supported by the express language of the relevant statutes and regulations. See secs. 842 and 864; Treas. Regs. §§1.864-4(c)(2) and (3).

Section 842(a), provides in relevant part:

> If a foreign company carrying on an insurance business within the United States would qualify under part I...of this subchapter for the taxable year if (without regard to income not effectively connected with the conduct of any trade or business within the United States) it were a domestic corporation, such company shall be taxable under such part on its income effectively connected with its conduct of any trade or business within the United States. With respect to the remainder of income which is from sources within the United States, such a foreign company shall be taxable as provided in section 881.

In general, section 864(c) defines effectively connected income. Under section 864(c)(1), "for purposes of this title," a foreign corporation engaged in a U.S. trade or business during the taxable year determines its effectively connected income under the rules set forth in section 864(c)(2),(3), (4), (6), and (7). Section 864(c)(2) generally provides rules for determining whether periodical income from sources within the U.S. or gain or loss from sale or exchange of capital assets are effectively connected to a U.S. trade or business. In making this determination, the factors taken into account include whether (a) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or (b) the activities of such trade or business were a material factor in the realization of such income, gain or loss. Sec. 864(c)(2); see Treas. Reg. § 1.864-4(c)(2)(application of the asset-use test). For this purpose, due regard is given to whether or not such asset, or income, gain or loss was accounted for through the trade or business. Sec. 864(c)(2); see Treas. Reg. § 1.864-4(c)(4). All other income, gain or loss from sources within the U.S. is treated as effectively connected with the conduct of a U.S. trade or business. Sec. 864(c)(3). Section 864(c)(4)(C) provides in the case of a foreign insurance company any income from sources without the U. S. which is attributable to its U.S. business is treated as effectively connected with the conduct of such U.S. trade or business. See Treas. Reg. § 1.864-5(c).

In summary, section 842(a) provides that a foreign insurance company doing business in the U.S. is taxable under Subchapter L on any income effectively connected with any

U.S. trade or business. For purposes of the Internal Revenue Code, section 864(c) defines income that is effectively connected with a U.S. trade or business. It follows that a foreign insurance company determines the amount of income effectively connected to its U.S. trade or business under the rules in section 864(c). No special rule was provided for foreign insurance companies except section 864(c)(4)(C) and Treas. Reg. § 1.864-5(c) concerning the foreign source income effectively connected to the conduct of a U.S. trade or business of a foreign insurance company. Thus, Taxpayer's claim that an insurance company determines its effectively connected income based on the amounts reported on its NAIC statements per se has no statutory or regulatory basis.

Taxpayer claims that its position is supported by language in the legislative history of the 1966 Act stating that "the annual statement of its U.S. business on the form approved by the National Association of Insurance Commissioners will usually be followed." H.R. Rep. No. 1450, 89th Cong., 2d Sess. 31, 32 (1966); S. Rep. No. 1707, 89th Cong., 2d Sess. 38 (1966) (emphasis added).

In the BB TAM, we previously considered and rejected Taxpayer's argument that NAIC statements are determinative of the amount of effectively connected income under section 842(a) based on the language in the legislative history of the 1966 Act. When the meaning of a statute is clear, it is both unnecessary and improper to resort to legislative history to divine congressional intent. U.S. v. Locke, 471 U.S. 84, 85 (1985); Edwards v. Valdez, 789 F.2d 1477, 1481-1482 (2nd Cir. 1986). Because the clear language of sections 842 and 864 applies to foreign life insurance companies, it questionable whether it was reasonable for Taxpayer to rely on an interpretation of legislative history that it believes conflicts with the statutory language. In our view, however, as indicated in the BB TAM, the legislative history does not support Taxpayer's position, but, rather, is consistent with the holding of the BB TAM.

Furthermore, the legislative history of the 1966 Act also states in a different section that "[i]n determining for purposes of subchapter L whether a foreign corporation is carrying on an insurance business in the United States, and whether income is effectively connected with the conduct of a trade or business within the United States, section 864(b) and (c), as added by section 2(d) of the bill, shall apply." H.R. Rep. No. 1450, 89th Cong., 2d Sess. 94 (1966). Thus, the legislative history states that a foreign life insurance company applies the standards set forth in section 864(c) to determine the amount of its effectively connected income. As noted above, section 864(c) and the regulations provide express standards for determining effectively connected income and omit any per se test based on the NAIC statements for foreign insurance companies.

A foreign life insurance company had sought unsuccessfully to have statutory language included in the 1966 Act that would have created a special standard in section 864(c) for determining the effectively connected income of foreign life insurance companies based on NAIC statements. Letter from the Manufactures Life Insurance Co. to the

Joint Committee on Internal Revenue Taxation (Jan. 19, 1966), Legislative History of HR 13103, Sec. 11, at 161 (1967). Given Congressional rejection of a special standard for the foreign life insurance industry from the general effectively connected principles in section 864(c), it is questionable whether relying on an interpretation of legislative history that does not clearly provide for such a standard is reasonable, especially in light of the clear and explicit provisions of the statute and regulations.

Taxpayer claims that government personnel led taxpayers to believe that NAIC statements were to be used to determine the amount of effectively connected income of foreign insurance companies. Taxpayer does not cite any published guidance or other rulings issued by the government stating that NAIC statements should be used by foreign life insurance companies to determine the amount of effectively connected income. Taxpayer simply refers to the legislative history of the 1966 Act (discussed above) and 1987 Omnibus Budget Reconciliation Act (H. Conf. Rep. No. 100-495 at 983 (1987)) in support its position and to unspecified commentators and Service personnel.

As discussed above, in the BB TAM, we considered and rejected Taxpayer's contention that the language in the legislative history of the 1966 Act shows Congress intended that foreign life insurance companies should determine their effectively connected income based solely on their NAIC statements. We also considered and rejected Taxpayer's contention that a reference in the legislative history in the 1987 Omnibus Budget Reconciliation Act to a non-existent regulation supports its position that a special standard based on NAIC statements applies to foreign life insurance companies. Taxpayer's position with respect to this statute has never been ratified by judicial holding or official agency action, and accordingly, Taxpayer may not claim detrimental reliance on its interpretation of law. See Dickman v. Commissioner, 465 U.S. 330 (1984);Knights of Columbus Council, 783 F.2d 69.

We note that any reliance on the personal opinions of commentators or IRS personnel about the proper interpretation of a statutory provision is not a basis for granting section 7805(b) relief. We further note that we have denied section 7805(b) relief in circumstances similar to those of Taxpayer. Murphy Oil USA, Inc. v. U.S., 81 F. Supp. 2d 942; 2000-1 U.S. Tax Cas. (CCH) P70133; 85 A.F.T.R.2d (RIA) 417 (W.D. Ark. 1999).

Taxpayer has failed to demonstrate that section 7805(b) relief is warranted. Accordingly, we conclude that the technical advice memorandum should be retroactively applied to Taxpayer.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.