RECORD, Volume 23, No. 3*

Washington Annual Meeting
October 26–29, 1997

Session 28PD
Taxation of Multinationals

Track: Financial Reporting/International
Key words: Taxation, Financial Reporting

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Summary: As more companies are looking to expand offshore into global markets, company tax professionals will be seeking help from actuaries in calculating certain elements of their tax returns. Actuarial issues relative to multinational taxation are identified. This session is of particular interest to those actuaries wishing to be a key participant in the tax planning process, and for those wishing to understand U.S. tax effects on products sold in foreign subsidiaries or branches.

Mr. Charles (Bud) D. Friedstat: I'm a director with KPMG/Peat Marwick in Chicago and I'm serving as the moderator for this session. With the insurance marketplace moving toward a global basis, and with U.S. companies expanding to offshore and other global markets, we really have a situation where taxation of multinational corporations is becoming more significant. Our panel will be talking about three aspects of this.

First, we have Dan Horowitz who is a senior partner with Groom and Norberg. Dan will be starting us off by giving us an overview of U.S. taxation of life insurance income from controlled foreign corporations. This is a particularly timely subject, and Dan will tell us what has happened over the past year. Some of the legislation and possible changes in legislation may have a direct impact on this topic.

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Ed Robbins will be the next speaker. Ed is a Senior Actuary at KPMG Peat Marwick in Chicago. He'll be talking about some of the actuarial aspects of taxation of controlled foreign corporations.

The final speaker will be a company representative who has had direct experience in this area. Jim Cohen is vice president and senior tax counsel with Aetna. He'll be talking about some of the experiences he has had through minority-owned corporations. I think you'll get a very balanced picture of this and get a good introduction to some specifics.

Mr. Dan Horowitz: I've watched a lot of companies look at foreign operations and the initial emphasis is almost always on the foreign environment. How do we get a license? What's the market like? What can we sell and so forth? Not much attention is paid initially to the U.S. tax rules and how they might affect things. We would usually have the tax people off to the side saying, "The law was changed in 1986, and when we make money we're going to have to pay U.S. taxes," but no one would really pay much attention to that. CFOs were saying, "It's going to be a long time until we make money, and when we make money, we'll worry about that. Finally, we are at a stage now where some companies are making money and other companies are seeing that they will be making money soon. They're being told again by the tax people that there really is some U.S. tax that they are going to have to pay, even if they don't have much income for foreign regulatory or foreign tax purposes. They are still going to have U.S. tax to pay. People are getting very upset about that.

The basic problems that the industry faces, from a competitive point of view and in terms of tax, can be described in two aspects. One is that the U.S. tax on operations of controlled foreign corporations (CFCs) is greater than U.S. taxes on other industries' CFC operations and greater than foreign taxes on foreign life operations. U.S. shareholders own more than 50% of the company. The most typical pattern is a wholly-owned subsidiary, which would be a controlled foreign corporation. Jim will talk about situations where we do not have controlled foreign corporations.

The U.S. taxes on life insurance CFCs are generally harsher than they are on CFCs in other U.S. industries that are going abroad. They also generally result in a greater overall tax burden, or at least a U.S. tax burden that is greater than the overall tax burden that our foreign competitors are paying in the foreign country. Whether there is a host country burden or a home country burden, most countries do not tax foreign life insurance subsidiaries the way the U.S. does. So we're seeing additional tax burden on foreign subsidiaries and U.S. life companies, which affects the bottom line and affects the ability to compete with after-tax returns.

The U.S. has what's called the worldwide tax system. Wherever a U.S. corporation operates, all of its income is taxed currently by the U.S. subject to a foreign tax credit for taxes you pay in a foreign country. The regimen is very different for foreign subsidiaries. Generally the U.S. parent of a foreign subsidiary is not currently taxed. The U.S. parent does not pay tax until the earnings of the foreign subsidiary are given as a dividend back to the parent. As a foreign subsidiary, the main tax benefit of setting up a subsidiary is to get a deferral from U.S. tax. If you are paying less tax in the foreign country than you would back in the U.S., if you can incorporate as a foreign subsidiary, and if you can succeed in not paying U.S. tax through the deferral, then there's an obvious advantage of operating through the subsidiary.

There's a major exception to this general rule of the U.S. not currently taxing earnings of foreign subsidiaries. That exception is found in what is called Subpart F. Those of you who work closely with different aspects of the Internal Revenue Code know there are chapters, parts, titles, subparts, and subchapters, and one group of sections is called Subpart F. It is just the way the code is divided up. Under Subpart F, contrary to the general rule, the U.S. parent is taxed currently on certain types of earnings of its foreign subsidiaries. These certain types of earnings are impossible to describe through a single basic concept. One type of income that is currently generally taxed in the Subpart F is passive income. The concern of U.S. policymakers was they do not want U.S. taxpayers taking their passive funds which they could be investing in the U.S., and investing them offshore. Policymakers don't want them investing offshore for tax reasons, and so we'll tax the earnings currently.

The more generalized concern has to do with movable income. There's less there than meets the eye. It kind of started with sales subsidiaries. Companies would set up a special sale and service subsidiary known as base companies. The basic purpose was to siphon money out of high-tax countries where manufacturing or the basic operations were being run, and instead run the income from the operations through low-tax countries. That type of movable income was also brought within Subpart F.

Subpart F has been expanded to really include other forms of tainted income. That's really in the eyes of the beholder. One policymaker or another doesn't like something that's going on overseas, and makes an attempt and sometimes succeeds in bringing it into Subpart F. The general rule is when you're dealing with third parties and/or you're dealing all within one country, Subpart F generally does not apply. There's really no other industry where you are both dealing with third parties as we generally do if you're talking about other-than-related party

reinsurance. If you're dealing within the same country that your customers are, there's no industry that's subject to Subpart F other than the life insurance industry.

Subpart F really can only be understood as a hedge-podgy ad hoc set of compromises between two basic policy views. One policy view is U.S. taxpayers should be taxed currently by the U.S. wherever they are, no matter what form of operation they use (even if it is a foreign subsidiary). The other policy is foreign operations should not be subject to U.S. tax, no matter what the form. There's no single basic concept. You just have to learn the particular rules for the particular industry. It's really bereft of a basic concept at this point.

Now in terms of life insurance companies, I've been alluding to the harsher rules. Let me just get to the basics of those and show you how they are harsher. Same-country insurance is insurance where the policyholder or the risk is located in the controlled foreign corporations' country of incorporation. Same-country insurance in Subpart F does not apply to the net premium income, but does apply to net investment income. As we'll see in a moment, how you define those terms is not self evident. You divide up your earnings into premium or underwriting income, and investment income on the other side, and you're taxed on investment income but not premium or underwriting income.

In cross-border insurance you can imagine that risk is located in a country that is different than the CFC country of incorporation, and all of the net income is taxed currently to the U.S. parent as Subpart F income. The rationale in 1986, when these rules were instituted, was that insurance income, and certainly the investment income that's earned by insurance companies, is movable income. There are many theories as to how these provisions got applied to basic life company operations. Some people think that we got swept up in the general hostility toward captive insurers that were commonly being placed offshore, in part, for tax reasons. Others thought that the real concern was with reinsurance. But whatever the concerns were, even same-country life insurance operations or same-country casualty company operations were swept under the Subpart F rules. It really doesn't make a lot of sense for same-country insurance because there's no movable income there. Your customers are local, you set up locally, and your premiums are coming to them. You may invest outside the country, but that investment income will be subject to the tax regime of the country in which you incorporated. There really is no reason that it should be called movable income. Since the time the 1986 Act that put in this rule was enacted, there has been some recognition on the part of people both on the Hill and in the Treasury that we shouldn't have been swept up into that. Nonetheless, the rules are there, and they've been quite difficult to deal with.

Even for cross-border insurance, it's not really clear that we're talking about a special kind of movable income. After all, you can set up manufacturing operations in a tax haven country specifically in order to save taxes, and you're generally not going to be subject to Subpart F. So even on cross-border insurance, there are some countries, but certainly with regard to the predominant pattern in the life industry of the same country risks, there really is no good basis for this.

These are the rules, but how do we try to deal with them? There are basically two overall efforts that are going on at the government level. I'll distinguish what I'm talking about from the particular planning that individual companies do. One is to try to interpret the Subpart F rules as favorably as we can. Fortunately, even if people in the government believe that the rules shouldn't be the way they are, they still believe they have a set of rules they have to enforce. A number of companies have been getting together through trade associations and ad hoc groups to try to get those rules interpreted as favorably as possible. There also have been legislative efforts, and one is ongoing now which involves actually changing the statutory framework that we're operating under.

I'll spend a few minutes both on the interpretation of Subpart F and on the legislation. We have proposed regulations now in Subpart F that were proposed in 1991. It should not take six or more years to turn something into final regulations. It's a very difficult area for the government or for anyone to deal with, in that it requires expertise in both insurance taxation and international taxation. These are two areas that, on their own, are quite arcane enough and when you combine them, you don't find many people who can deal with both. The government has had trouble doing that. So we've been living with these proposed regulations.

Finally, a really strong effort is going on in the Treasury and the IRS to finalize some set of regulations or to at least re-propose new regulations. It's not clear what will happen. They are talking about getting those out by the end of the year. This is not the first year we've heard that. So we take it with a grain of salt. On the other hand, they have made a lot of progress now. It is not just an entry on a business plan that says to get it out by the end of the year. There are substantial draft regulations being circulated and reviewed. And while I would still bet against them coming out at the end of 1997, I think there's a pretty good chance they will come out. I think there's an even better chance they'll come out within the first few months of 1998.

We've been working on four basic issues under these regulations. First is reserves for failed contracts, and by contracts I mean contracts not meeting the U.S. definition of life insurance. Do you get a reserve deduction? Assuming you have a contract that you do get a reserve deduction for, how do you compute it for Subpart

F purposes? How in the same country context do you allocate expenses between premiums and investment income if it's only the net investment income that's subject to Subpart F? How do you apply the deferred acquisition cost (DAC) rules to CFCs?

The overriding concern that comes up here is that U.S. policymakers generally believe (and it's almost a matter of religion) that U.S. principles should govern the taxation of U.S. persons, even under Subpart F and even if you're getting taxed indirectly on your income of a foreign subsidiary. That's the root of the competitive problem that we have in terms of the tax burden that the Subpart F rules impose.

Let's discuss the reserves for failed contracts. There's a technical problem here in that the definition of life insurance reserves, in the Internal Revenue Code, refers to the definition of life insurance and annuity contracts. If you're the government you argue that you don't get any reserve deductions if your products don't meet the U.S. definition of life insurance or annuities, which they commonly do not, because foreign marketplaces are different from the U.S. marketplaces. Now as a conceptual matter this should not be a problem. The definition of life insurance addresses policyholder tax issues, not company tax issues. It doesn't change the true liability of the company. Under this vision, the investment component for the contract results in individual taxation back in the U.S. This has been generally recognized by at least some people at the IRS and the Treasury department. They came close to clarifying it favorably for us in the 1991 proposed regulations, but at the last moment, for a variety of political reasons, the issue was just left alone. There are no rules in the proposed regulations. Those of us working on it expect that this issue will be favorably resolved, and that there will be reserve deductions for failed contracts. You'll determine whether something as life insurance without 7702, and some of the other provisions that have come into U.S. law over the years, to deal with policyholder tax issues and not company tax issues.

One caveat is that the Treasury and IRS have become aware of some companies that apparently are advertising to U.S. citizens to come over to one country or another and they're advertising to the U.S. citizens to buy a life insurance policy in the other country that does not meet the U.S. definition of life insurance so they don't have to pay U.S. tax. They're incorrect if they're telling their policyholders that but, in any event, our government is concerned that they'll never find out about it. We expect the regulations to have a rule that you won't get reserves on failed contracts. As the policyholder beneficiary, you're insured as a U.S. person. For major U.S. companies going overseas, this isn't a real problem. They are not trying to lure U.S. people over to buy their products. The problem that's going to come up is a practical one pertaining to what level of proof the IRS is going to require you to

show that you don't fall within one of these categories. That remains to be seen, but I think there is real cause for concern as to how they'll deal with that.

The next issue is reserve computation. The three factors are: mortality, interest rate, and method. On mortality, the basic issue is, are you going to use foreign versus U.S. mortality tables? That seems totally logical. The proposed regulations say to use foreign mortality tables, and we expect that to be maintained in the final regulations.

Interest rates present a different issue. The industry has, for the most part, argued that we should use foreign interest rates because that's the interest rate that applies in the relative economic environment. When the industry has talked about foreign interest rates, what we've generally meant or hoped was going to come about was foreign regulatory interest rate. The IRS and Treasury have generally fought the notion that it should be foreign interest rates; however, they have not generally bought the notion that it should be foreign regulatory rates. They think it should be similar to Section 807 in the U.S., and it should be the greater of the highest foreign regulatory rate allowed, or some foreign applicable federal rate (AFR) analog. The proposed regulations were intended to say something like that; however, they were written in such a garbled form that they can readily be interpreted as allowing the use of foreign regulatory rates, which is what many companies have been doing. In the final regulations, we expected clarification that it's the greater of foreign AFR analog and the highest foreign regulatory rates.

In terms of the method, the regulations can be read as allowing foreign regulatory methods as long as they're not in excess of net level. We expect the final regulations to require the U.S. method that would be required for that type of product. So Commissioner's Reserve Valuation Method (CRVM), for a basic life insurance policy, and then with whatever variations are necessary to deal with other types of products, such as Commissioner's Annuity Reserve Valuation Method (CARVM) for annuities. The products vary so much that adaptations need to be made, but it should be under the same basic standards that would govern you if you were doing it in the U.S.

Expense allocation. I was going to talk about the basic principle of expense allocation. There''s a general principle not only of tax law, but of cost accounting. Generally, you want to allocate expense to the type of income the expense generates. This simply stated principle has always generated great problems in the life insurance industry. We divide up our financial statements into investment income and underwriting income, and segregate expenses in that way. It really does not make a whole lot of conceptual sense, particularly if you're talking about reserves and benefits. Even basic expenses and commissions, which are generally

computed as a portion of premium, are a significant part of the reason that insurance companies are paying a commission to their agent. They can get money that can be invested and earn investment income. So there really is a good argument for allocating some portion of commissions against premiums on a conceptual basis. There is this long history of the industry not using these types of accounting procedures. Once you get over that hurdle, you'll find it is a mystery as to what is the right way of doing it, especially for life companies.

There's an additional problem that comes up in the minds of the Treasury and the IRS, which is having to deal with the surplus of life insurance companies. Their model is, life insurance companies, like other U.S. taxpayers, are trying to just put as much money offshore as they can and they are overcapitalizing their subsidiaries. The Treasury and the IRS believe they shouldn't allow any expense allocations to investment income earned on this surplus. The industry has tried to convince them that surplus is a scarce commodity and people are not looking to just dump it overseas. They feel that they need rules to deal with those who might do it, and so this keeps coming up again and again.

We expect this expense allocation issue to come up in a general gross-to-gross allocation. The current regulations have complicated formula reserves, dividends, and benefits. You basically get a deduction for required interest against your investment income. It's done with a series of formulas that are complicated to lawyers, but perhaps not to actuaries. There are different formulas for each of those reserves, dividends, and benefits. Other expenses are sort of left unclear. We expect to have an overall gross-to-gross allocation of expenses, including reserves, dividends, and benefits between premiums and investment income. There will likely be a special direct allocation for separate account types of products. Investment income on reasonable surplus, which we expect to be in the range of 10% of reserves will fall within this gross-to-gross allocation. You'll be able to allocate expenses to investment income on the reasonable surplus, but investment income on any surplus over and above that will not come within the gross-to-gross allocation.

Finally, regarding DAC, the U.S. principle is that we need to capitalize policy acquisition costs. There are real problems in applying the U.S. rules in a foreign context. They have very different facts in terms of lapse rates and cost structures. The principle of capitalization in the regulation doesn't explicitly deal with DAC. The proposed regulations are best read as requiring DAC, and we expect it to be clarified that you will have to apply DAC and do it under the U.S. rules of the ten-year spread and so forth, just as if it were in the U.S., despite whatever factual differences there might be.

What we expect out of the regulations would be a significant improvement over the proposed regulations, particularly in the area of the gross-to-gross allocation and the treatment of failed contracts. There will be substantial competitive problems because of the income that remains taxed.

There's now legislation being considered, and there was legislation that was part of the tax bill. We were actually subject to the first line item veto, so it was vetoed. That legislation has now been modified greatly to meet the objection of the Treasury department. Basically what those rules will say, if they are enacted, is for same-country insurance, you'll not only exclude your premium income, but also investment income earned on reserves and investment income earned on reasonable surplus. Reserves will be defined under U.S. principles (that is foreign mortality tables and foreign AFR analog), but U.S. methods will be used, such as CRVM. You will have DAC rules and you will get reserves for failed contracts, but only where the policyholder insured and the beneficiary are not U.S. citizens. So all those issues get resolved the same way.

Basically the benefit to this legislation is that you get your investment income on the entire reserve rather than just getting required interest. I should say, you get the entire investment income on the reserve, and you also get investment income on surplus. However, you still get taxed currently in the U.S. on any investment income on surplus above that. Once you apply these U.S. reserving principles and DAC, you may well have substantial surplus.

The bill is now tied up in the House. It was approved in the House Ways and Means Committee, but there's now a debate going on between the Budget Committee and the Ways and Means Committee. The Ways and Means Committee theory was, you didn't have to come up with revenue to pay for this because it was in the originally enacted overall tax bill, which presumably had revenue for it. The Budget Committee is balking. Apparently, some compromise has been reached in which they are going to find revenue to take care of this on the spending side and not on the tax side.

Overall, I think most legislators will think the prospects are pretty good, but it's still uncertain. Assuming that it does get enacted, I do think there will be a significant benefit. There are going to be these significant problems because of the greater demand of surplus you'll have in terms of U.S. concepts as compared to foreign concepts. I think that's going to shift a lot of the planning and attention to planning in the foreign countries. I think a good analog for a lot of us is what happened in the states when we went away from state law reserves to tax reserves. Companies had to really work on their state law reserves to get them down, while also working on their tax law reserves, assuming that they could get them up. I think the same

kind of process will go on, and we will really be pushing hard to see if we really need as much in the way of funds, so that even once DAC and these reserve principles are applied maybe we can get below this 10% surplus level. I think that's where a lot of the attention is going to turn. It's going to be very difficult, from a practical standpoint, because it will require close communication between the U.S. parent and the foreign subsidiary, and that is difficult to achieve. That's what other industries have to do. If the U.S. insurance industry is going to remain a major player or become a major player overseas, we'll have to learn how to do the same kinds of things.

Mr. Edward L. Robbins: To put things in more of an actuarial context, I'm going to have to repeat a little of what Danny Horowitz has already covered. The concepts are so complex that they probably bear repeating. I'll be getting into somewhat more detail on reserve issues.

I've titled my presentation, "Actuarial Aspects of Subpart F Income." I've always suspected that anything entitled, "Actuarial Aspects of" could often mean that the speaker knows only the actuarial aspects. To a great extent that's true. Those are the aspects I've worked with and I'm nowhere near an expert in taxation of multinationals like my two colleagues on the panel. In the interest of rounding out my presentation, and putting it in the proper context, I'm about to frame the issue and tell you a few things that are a bit beyond what I understand. I'll deal with the actuarial aspects where I've had the experience.

What is Subpart F? It is code Sections 951 through 964, titled, "Controlled Foreign Corporations" (CFC). Basically, as Danny indicated, Congress was very aware of the perceived abuse of companies parking assets overseas, in order to earn investment income on those offshore corporations that were not subject to tax until repatriation. This was the impetus of this section of the statute.

Subpart F is an after-tax concept, and it's limited by another asset tax concept called earnings and profits (E&P). Subpart F income cannot exceed E&P. What is earnings and profits? A very oversimplified approach to E&P is to take an annual statement summary of operations, and slide in changes in tax basis assets and liabilities in place of your statutory changes in assets and liabilities. In other words, move in your increase in tax reserves as opposed to your increase in statutory reserves, and so on. Any resulting excess of Subpart F income over E&P is carried forward without a time limit. That's one instance where an indefinite carryforward is actually bad rather than good.

Many of you are aware of offshore captives that happen to be U.S. taxpayers. There is an election that a parent can make for an offshore subsidiary to be a U.S.

taxpayer, and at times, it can be very complex and difficult to tell whether it's better to have the offshore subsidiary be the U.S. taxpayer or Subpart F taxpayer. I haven't personally put pencil and paper to it. I know that this is an area that's ripe for actuarial research. I haven't dealt with the rules for taxation in the local country, the multiple inside limits on foreign tax credit recognizable, and the Subpart F rules themselves, which, as Danny indicated, are extremely complex.

Once you do elect for your offshore subsidiary to be a U.S. taxpayer, that is virtually an irrevocable election, so you want to be reasonably sure when you make that election that that's the way you want to go. There are probably many potentially rich areas for actuarial tax researchers that are begging for some research. I can think of a couple of such areas where someone could really make a contribution to this area.

What marginal tax rates should you be using when you price a product in a CFC? You must know the local company tax, the foreign tax credit, the Subpart F income, and so forth. This is a complex question. The second complex question is, what's the most tax efficient way to repatriate dollars to the U.S. parent? Is it via shareholder dividends? Is it via service fees? Is it via reinsurance? Of course, these rules have an impact on that. In the long run, you also need to be thinking in terms of the currency of the country. If it's a highly inflationary country, maybe the speed of repatriation of dollars is an important issue in your analysis of internal rates of return, and on pricing your product in a controlled foreign corporation.

In any case, what I'd like to do is just basically talk about when the company does not elect for the offshore subsidiary to be a U.S. taxpayer and when the offshore subsidiary is subject to Subpart F income. I understand from the tax practitioners, that carryovers, carryforwards, and carrybacks of negative Subpart F income are extremely restricted. They talk in terms of qualified deficits from qualified activities. Those areas are extremely tough to qualify for. You can assume that you'll be substantially restricted in carrying forward or carrying back deficits. The question is, if you're going to start up a subsidiary in the country, and you're going to have initial tax basis losses, the Subpart F losses, you're going to have to live with some tax inefficiency. In a controlled foreign corporation, you're talking about greater than 50% ownership. This is the issue of carrying forward capabilities and limitations on it.

What are the constraints on Subpart F income? First, there's no small life company deduction. For a company that owns 60% of an offshore subsidiary, so that it's not a controlled group, you would ordinarily think you could get a small life company deduction there. That is not true. There is no small life company deduction and no net operating loss carried forward and no recognizable capital loss.

Now that we've set the stage, let's talk about the statutes. Danny and I have talked about the proposed Section 953 regulations to some extent. We're getting down to the so-called actuarial aspects of Subpart F income. Talking about actuarial aspects of someone else's business touches a nerve with nonactuaries, too. A long time ago, when I was studying for part ten of the actuarial exams, we had a study note on the syllabus called, "Actuarial Aspects of Agency Problems." I was studying this and the superintendent of agencies of our company came by and said, "You stick your nose into everybody's business don't you?" He was actually a pretty sharp guy. He said, "You know, on the Certified Life Underwriters (CLU) exams we have a study note called, 'Agency Aspects of Actuarial Problems'."

Anyway, you're basically talking about dividing income into income from premiums versus income from investments. Those of you who operate in the property/casualty sphere, see that as premium income. There is underwriting income versus investment income, and the concept is similar. It's not terribly logical on long tails of property/casualty lines. It's far less logical on life insurance and annuities. It doesn't really work all that well, but that's the structure of the statute the way we have it. Think in terms of a two-by-two grid. You have income from premiums, income from investments, and you have the same-country income versus the non-same-country income. Only the same country income is free of taxation from Subpart F. Premium base is same country income, and so is income on residents of the host country of the offshore subsidiary. The after tax total of that equals E&P after tax.

The offshore subsidiaries of U.S. parents typically insure only residents of the host country. You don't have to worry about a two-by-two dimension. You only have to worry about the split between premium-based and investment-income-based income.

To give us a little bit of focus about strategic directions on tax reserves, I want to talk a little bit about two strategic directions, and I'm going to add a third. Danny referred to the ambiguity involved in separating income into premium-based and investment-based categories. The proposed regulations have a set of formulas that give you kind of a tabular interest figure but not the kind of tabular interest you get from your analysis of increase of reserves on a statutory basis. The formula is nothing like that. Actuarial practitioners in the area feel that the formula is badly flawed and gives rise to some severe anomalies. Therefore, there's a lot of variation of practice as to how you deal with the proportioning between premium-based income and investment-based income.

There are two strategic directions: maximized tax reserves and the maximized investment income deduction approach on such tax reserves. We want to

maximize the tax reserve for two reasons. The first issue is maximizing tax reserves in a growing offshore subsidiary generally lowers total Subpart F income. The second is because maximizing tax reserves will generally give us the most investment income deduction against investment-based income. There's a third strategy that I just wanted to add. Because loss carry forwards are so restricted, you may not want to create the type of negative income that will eventually reverse and cause heavy positive income later on.

Dan described the rules pretty well. Let me go through the rules on reserves in a little bit more detail. You've got a deemed statutory ceiling. What is the statutory ceiling with respect to subsidiary company offshore reserves? In your typical controlled foreign corporation, it's basically the reserve held with respect to the policy in the host country if the insured is a resident of the domiciled country. If the insured is a resident of the U.S., the proposed regulations state that you must use the New York minimum statutory standards. If the insured is a resident of the third country, use the third country's set of standards.

Now that we've defined the cap, let's go to the special rules for U.S. type reserves. They're subject to the statutory ceiling that I just defined. But then you get into another kind of two-by-two, if you will. For life contracts, you have qualified contracts versus nonqualified contracts. Qualified contracts are basically analogous to the qualified foreign contract subsection of 807. The definition of a qualified contract is a contract issued by the controlled foreign corporation. The insured should be a resident of the CFC home country or host country, and the country cannot be contiguous to the U.S., so this would exclude Canada and Mexico.

So that's the definition of a qualified contract. For qualified contracts, use the host country equivalent of the greater of the so-called highest statutory rate or the applicable federal interest rate (AFIR) equivalent in that country. In other words, take very highly qualified assets in the host country, get averages of three-to-nine-year maturities, take a 60-month rolling average of it, and you'll have the local country equivalent of the AFIR. I would say these are the rules for a great majority of the offshore subsidiaries, once you're outside of Mexico and Canada.

For nonqualified life contracts, you must use the U.S. AFIR. For example, for Canada, which is a contiguous country, life contracts are nonqualified and the U.S. AFIR must be used. The U.S. prevailing statutory mortality table like '80 CSO, must be used, as well as the U.S. tax reserve method.

I'm not going to spend a lot of time on the calculation of this tabular interest thing. Basically there's too much variation in practice to take that formula seriously. Section 846 deals with cancellable health business and with property/casualty

business (basically claim reserves and claim liabilities on those two types of business). Group long-term disability (LTD) is probably, by far, the biggest example of Section 846 type contracts. Section 846(f)6 talks about cancellable health business that is subject to rules that are analogous to property/casualty claim reserve discount rules. For LTD-type contracts, use the interest rate generated for qualified contracts or that host country equivalent of the AFIR, based on the incurred date of the claim. The practice, just like it is in the U.S., according to the proposed regulations, is to use the loss-payment pattern that reflects the experience of the taxpayer. For property/casualty contracts the proposed regulations say, to use the treasury loss payment pattern. Those of you who are into property/casualty business know the Treasury comes out with these loss-payment patterns, and you simply have to apply them, unless you choose to use your own rules every five years under the redetermination year rules. As I said, these are the rules in Canada and Mexico.

The required interest formula is very complex and very inconsistent with Code Section 812. I don't know why they didn't simply say, use the Section 812 rules on the reserves. It is kind of an average required interest rate times the reserves. That would have been a whole lot easier than the formula they came up with.

It's a rather complex area, and, as was stated earlier, U.S. multinationals put themselves at a tremendous disadvantage. It puts a U.S. company writing business for an Argentine subsidiary at a disadvantage relative to a British parent writing in an Argentine subsidiary. For example, I understand that this idea of taxing any type of income before repatriation is somewhat unique to the U.S.

Here again the proposed legislation that is now tied up in the House, and probably will not leave the House, has a neat approach of simply taking a tax reserve basis, based on the host country AFIR and the host country mortality, and actually making a tax reserve equivalent. The deemed surplus is added to that and you come up with this amount of investment income on assets equal to this piece. Tax reserves plus the deemed surplus are exempt. It's only assets that are parked in that host country above and beyond those tax reserves, plus deemed surplus, that would be subject to tax. Of course, any other tax based liabilities, such as DAC, would also be factored in.

One of the elements that you have to be careful of when you're looking at the pricing of CFC business, is if you're heavily reinsuring in a local country, for example. If your business is growing, you're not going to get tax relief from premium ceded that you're sending out right away. There's a special election in the final DAC tax regulations that allows you to accumulate the so-called negative capitalization that you're generating by ceding business to a non-U.S. taxpayer. Eventually, you'll get it back at the end of the time. If you continue to grow, it's

going to be tough to get it back in the near future. This puts a U.S. company at a significant disadvantage because the natural inclination of a foreign subsidiary is to reinsure locally, and a local reinsurer typically is not a U.S. taxpayer. You end up with that type of additional problem.

Let's hope that, in the absence of new legislation, the new proposed regulations that Danny mentioned, really do come out in the next few months.

Mr. James Cohen: I will talk about the tax aspects of owning a minority stake in a foreign company. There are three different ways to own foreign operations. The first is through a branch, which we have not spoken about, but it is fairly rare. The second, which you've heard about a great deal, is the wholly-owned or majority-owned company. From a managerial and business point of view, it is the way most people want to go. The third is through a minority-owned corporation. This last method is often not preferred, but for a variety of reasons, it's much more common than you would think, if only from pure economic analysis.

There are several reasons why minority interests are common. In the first place, there are a variety of foreign countries that simply prohibit foreign majority ownership. Thailand and India, for example, limit ownership to 30%. Brazil and Mexico permit no more than 50%. As these markets open, obviously the foreign government seeks to protect its local businesses and to maintain a level of control over the foreign operation by, in effect, prohibiting foreign control. Sometimes its not the government but your joint venture partner that turns out to be the sticking point. It's often difficult to enter a country without a partner who is knowledgeable about local market conditions. In the different situation between the buying and building, you'll often seek to own a smaller piece of an operating venture rather than start at the ground floor and build against the competition.

In many emerging markets where my company is most active, there are often only a few key players, and often it's desirable to buy into their operation as opposed to starting from scratch. These local ventures are often very large, usually very successful, and as you can imagine, are often less than wildly enthusiastic about ceding control of very nice companies to American adventurers, so they'll often seek to control at least 51% of the operation.

Finally, and not irrelevantly, it's expensive to enter foreign markets. If there are 160 countries in the world, and the minimum capital needed to enter each is $10 million, that's a lot of money. Obviously not every country's market is desirable for every insurer, but some countries are extremely large. I don't mean only the People's Republic of China, for which my company has just gotten a license that we

are very excited about. The amount of capital necessary to make a dent in those kinds of markets would be considered big by just about anybody. Even smaller countries often have very sizable capital requirements, and capital constraints seem to be the way of life in the late 20th century.

You've heard a lot about Subpart F; I'm not going to discuss it much more. The good news about minority ownership is that you don't have Subpart F concerns, which means you avoid current U.S. tax on the deemed repatriation of some portion of your profits. You also heard a little bit about the basic test, which is why the U.S. shareholders, those that are 10% or more owners, control more than 50% of the company by vote or value. The strict 50/50 ownership, which is not at all uncommon, is not a CFC. You even have 50/50 companies, where the U.S. company appoints the managing director or some other key person who runs the company on a day-to-day basis. That doesn't change the rule provided the managing director has no more voting control over those matters properly brought before the board of directors than any other director. On the other hand, if a U.S. company owns 60% of the voting stock, and the 40% foreign owner can veto any decision of substance by requiring super majority decisions by the board, it is still likely that what you have is a CFC. The 50/50 ownership situation is very common. I like to call it the bigger 50 and the smaller 50. This analysis often involves very close cases of whether you're the bigger 50 or the smaller 50. This is bread and butter for a tax lawyer. This is what we do for a living. And you thought you had a bad job!

I find that business people are often perfectly willing to have a CFC if they can have ownership control. That 51% ownership is a bad thing from a narrow tax lawyer's point of view, but it's by no means a bad thing from an operational point of view, even though you are paying current tax on money that isn't repatriated. It is possible to pay taxes on a current basis, even if you own less 50% of the company. This happens when you have a passive foreign investment company (PFIC), which is a company that has the bulk of its income from interest and dividends. It came into law designed to deal with offshore mutual funds and a variety of other tax scams. No one would have anything to do with it. You can own a minimal amount of stock and still find yourself currently taxed under the PFIC rules. This is not a problem for operating insurance companies or for holding companies of operating insurance companies because there's an exception. It can be a problem for subsidiaries of holding companies, which are not insurance companies, but are investment arms of foreign operations. So you can unwittingly find yourself in a PFIC situation and this is definitely a bad thing.

Going back to the minority ownership environment, I'd like to discuss what I call the vanilla structure. The foreign company is owned 60% by your foreign partner

and 40% by the U.S. company. As you now know, the tax is only triggered on a dividend out of the foreign subsidiary. However, it's not unusual to go into what I call the vanilla chocolate chip structure, which is only a little more exotic than plain vanilla. In that case, the foreign subsidiary pays a dividend, which does not go back to the U.S. But notice that the foreign corporation is 100% owned, and that makes the foreign company a CFC, which means there's a current tax on the distribution. This situation is, in fact, a great common business situation, where companies are attempting to invest cash in other foreign operations without repatriation to the U.S. The funds going up from the foreign subsidiary to the foreign company, even though they're headed back down to another foreign company, still go through the U.S. tax wringer at the time they are sent upstairs. There's really no way to take money out of the foreign subsidiary and send it up to the U.S. without paying that tax.

The foreign tax credit is the other side of the coin of the inclusion of income. The goal of the credit is to minimize the double tax by the U.S. and the foreign country. The Internal Revenue Code and tax treaties try to do this with what I would consider somewhat marginal success. There are so many tests and conditions that must be met, the credit often doesn't operate as a perfect offset. You pay your foreign taxes and the U.S. tax is reduced under the foreign tax credit. A couple of points should be kept in mind. One is that the credit is only allowed for taxes on income or taxes in lieu of income taxes. The simplest explanation of what is not creditable is the premium tax, which is done on a gross basis. That tax can be a creditable tax, if its imposed in lieu of an income tax. The test of that is whether the jurisdiction imposes an income tax on that particular class of taxpayer.

The most familiar example of that is Canada, where, before life companies were subjected to the income tax in 1969, the premium tax was in fact creditable. It was not only because there was a tax on income, but because it was regarded as a tax in lieu of the income tax. Since there's now an income tax in Canada, the premium tax in that country is no longer creditable.

The bread and butter of tax lawyers is close cases, where a careful analysis is required to determine if the tax really is imposed on income, as the term *income* is understood in the U.S. To meet that test, there have to be deductions such that what is left is the tax basis. It must be something that resembles net income in the U.S. sense. This is a favorite bugaboo of the IRS and a fairly developed body of law, which, unsurprisingly, mostly involves a natural resource that companies have developed.

An example that I know hits close to home for some of you is the Part 13 tax on the inside buildup on life insurance contracts, which was imposed by Canada.

Creditability of this tax looks fairly unpromising to those of you who, unlike me, are not actuarially trained. It's not imposed on actual income, but on a notionally constructed risk-free income from the investment and reserves minus a percentage of those reserves, and minus some other expenses. Not everybody on this panel agrees with me that the case is actually pretty good for claiming the credit, but the formula is a really ugly one and the case is certainly not clear cut.

In addition, to get the credit for an income tax, it must be compulsory. You may not think that sounds like much. Taxpayers have gotten into trouble because they've argued that it's not worth fighting the dubious imposition by a foreign government. After all, at the end of the day, if they pay the foreign tax, they'll get a credit for it against the U.S. tax. The IRS recognizes in that case the taxpayer is just a stakeholder, and so it requires that dubious cases be fought to the highest reasonable level. In fact, it sometimes seems that they require you to fight it to the highest unreasonable level. This has a big bearing on the standards that you adopt in claiming the foreign tax credit. Do you resolve debts in favor of or against yourself when you're making a tax payment to a foreign government? Obviously, in that context, you're going to want to think about whether you have done everything you have to do to make sure you have a creditable tax.

Another issue that's not so common for us, but is worth bearing in mind, is the question that sometimes arises about whether a tax is a tax or a royalty. Is it paid to the government as a government? Is it payment for some special benefit received by the U.S. company in the foreign country? Natural resource companies are the companies that have had to worry about this for a long time.

Foreign tax credits come in a variety of shapes and sizes. The most straightforward is the direct tax, which is the one paid on income by a U.S. company operating abroad through a division. As I said, this is not a common situation, although, in the early days, Canada was treated as the 51st state. I'm sure this was a situation that dismayed our good friends to the north. A few countries still require operations to be run through divisions of U.S. companies, such as Taiwan. Here again you're looking at a direct tax for the income tax, which is paid out of your Taiwan branch to the U.S. company.

Withholding taxes on dividends are also direct taxes. If this U.S. company owns a piece of the foreign corporation, and the foreign dividends are subject to a withholding tax imposed by the foreign government, that tax is treated as a direct tax on the U.S. recipient. This applies even though the U.S. recipient does not, in form, pay that tax, and often doesn't even see that tax. That's because the payment of this tax is treated as a legal obligation of the U.S. payee, unless it's a direct imposition on that company. The withholding rates very widely, and in the absence

of the treaty, they can be as high as 35%. The rates are that high because they're often the only tax imposed by the foreign government, particularly in the emerging market countries. These rates are also often reduced by treaties to 15% or even lower for dividends on significant equity positions. For example, and this is not atypical, the unratified treaty with South Africa, imposes a withholding rate on dividends of 15%, which is reduced to 5% if the U.S. owner owns 10% or more of the South African paying company. Of course, this tax is in addition to any subsidiary company level taxes which can vary. Although I think it's fair to say that rates in many commercially important countries have been coming down just as the U.S. tax rates come down.

I'd like to mention the state taxes. In the old days insurance companies didn't pay much attention to state taxes, except in the case of New York, Connecticut, Massachusetts, and Florida. There were few effective state income taxes to worry about it. Usually the foreign venture will be owned not through a domestic insurance company, but more typically ownership in your foreign companies is held through a general business corporation. If you do it that way, the laws of each of the states have to be examined. Many states exempt dividends, and some states exempt foreign dividends from tax. This is different though from the U.S. law, which generally excludes all or a significant portion of U.S. dividends and includes all the foreign dividends but gives to the foreign tax credit. I'm not aware of any states that actually give you a foreign tax credit. All they allow you is a deduction for foreign taxes paid. There's a situation in Connecticut, and Connecticut is not alone in this, in which a company can only take a deduction on its state return if it takes it on its federal. So if you don't take a deduction for foreign taxes but take a credit, you haven't taken the deduction; therefore, the state doesn't allow you a credit because you don't have one. They don't allow you a deduction because you didn't claim one. The state rates could be as high as 10%, and this is definitely a bad thing. Again, think about state, as well as federal taxes when you're looking at foreign operations.

Let’s discuss the limits on foreign tax. There is a formula that is designed to make sure that you can't credit foreign taxes, which are imposed at a rate higher than the U.S. rate. Since the U.S. rate is now 35%, this is a little more of an issue than it used to be. The formula states that foreign income over worldwide income times U.S. taxes paid is the limit on creditable taxes. If your foreign income is a $100, your worldwide income is $1,000, and your U.S. tax is $350, the limit on foreign taxes that may be credited is 35%. This sounds very simple and means that any rate below 35% of foreign tax rate would be fully creditable. The foreign income which is a 100 in my example, must be reduced by attributable expenses. Now I'm not talking about the expenses in the foreign company, such as the ones that got you down to 100 in the first place. I'm talking about expenses over and above home

office expenses. The salary and overhead expenses of the people who manage the foreign operations is obvious. There are some less obvious ones, like charitable contributions. The most complicated one is interest expense, which has its own rules. You are often in a situation where you have a lot of expenses that you may not think of that can make this limitation on foreign taxes much more of an issue than you think.

What about nonlife insurance companies where a foreign tax rate is more than 25%? That number is not magical. Rates can vary all the over place. If we have a foreign tax rate of more than 25%, it may not be creditable. There's a special rule for life insurance deductions which allocates deductions for reserves and death benefits payable to U.S. citizens against foreign income. This isn't a self evident rule. Why should the expenses of insuring U.S. citizens be charged against foreign income? The answer is, because the Internal Revenue Code says so. The effect of that is to cut your available limitation way down to the extent you're dealing with a life insurance company. This can be a very special problem, if your domestic life insurance company has to be the owner of your foreign operation. Now bear in mind that if your foreign operation is owned through a general business corporation, you have state taxes to worry about, as I mentioned earlier. If it's owned through a life insurance company you have this problem to worry about. This is a situation of being between a rock and a hard place, and why the tax lawyers make the big bucks.

In addition to the direct tax credit, there's a deemed paid credit, which is also a useful goody for minority ownership. If you're a 10% or greater corporate shareholder, you can claim credits for foreign taxes of foreign affiliates, which are as far down as the sixth tier below you. This is a recent change in law. Up until this year, the limit was three tiers, which given the complexity of the structure, was far enough. Six tiers is definitely far enough. Remember this deemed paid credit is only realized if and when the profits of the foreign subsidiary are paid back to the U.S. Just as you don't pay any taxes on that money in the U.S., you obviously don't get any credits until you repatriate, and then you get the deemed paid taxes that were internal to the company that's paying the dividend.

The math gets pretty ugly because you only get the percentage of tax as a credit, which bears the same relationship to all foreign taxes paid since ownership began. The dividend bears to the total E&P since the ownership began. That means if the total earnings of a foreign subsidiary are $300 and the total foreign taxes are $100, a dividend of $30 carries a foreign tax of $10.

Let’s say you have a subsidiary that's down six tiers, the dividend goes up to the fifth-tier subsidiary, and that company and some other subsidiary will have earnings

of its own and then to the fourth tier, and so on. I think of this as a little bit like trying to keep track of one car on the Los Angeles freeway, with hundreds of roads coming together. It is useful to think about it that way because, by the time you have tracked everything through and up to your U.S. company, you will have done a lot of math.

Now in a typical start-up situation, the earnings of your profitable affiliate will first restore your capital. The more successful you are, the more losses you're going to have early on, and the longer you're going to have to wait to probably make a distribution to replenish your capital. If you're growing the company, you'll wait even longer. That means that this deemed paid credit is going to be a very long time coming. It's something that you should bear in mind, but no one will tax plan around the goodies inherent in the deemed paid credit.

You've also heard that when you talk about earnings you don't mean GAAP or U.S. statutory or foreign GAAP or foreign statutory. What you mean is foreign earnings recomputed using U.S. tax returns. You have to go through all those calculations for this earning, which means that my reference to the Los Angeles freeway is probably more of a reference to the freeway at 5:30 in the afternoon. You have so many different things to worry about in calculating the earnings of the company.

Just to thoroughly discourage you, I'll say that the tax lawyer requires that each of your foreign subsidiaries have its own basket. This is what they call the 10-50 basket, and that term refers to ownership percentages in a foreign company between 10% (which is the least you have to worry about for foreign tax credits) and 50% (if there is more than that your price is in a CFC mode). If you're in the CFC mode, the good news is you don't have to worry about these 10-50 baskets. Everything goes to another basket which is actually a good basket. If you're in the 10-50 basket, it's not a single basket. You get a separate basket for every single company you own. I've heard of one oil company that had 1,700 baskets. I guess that's full employment for a taxi cab. The companies I'm more familiar with have nowhere near that many baskets, but they have plenty of baskets nonetheless. There are more than you can easily carry anyway. It has some substance significance in terms of limiting the credits because each basket is a limitation. The formula I went through earlier is done separately. It is a computational nightmare, such that I guess you could say it makes you grateful, as one so rarely is, for the invention of computers.

The good news on that front is that if you have a long enough time horizon, the 1997 tax law has changed. They're going to put all the earlier earnings of all these 10-50 companies into a single 10-50 basket. This will be effective in the year 2003. In addition, the concept of the 10-50 basket will essentially disappear in that year.

If you can just hang in there long enough to repatriate your money (assuming Congress takes no further action between now and then, which I think is a very dubious assumption) this problem is eventually going to go away.

I'm just going to say one word about the CFC issue again. Despite the problems you heard about from the first two speakers who described how nasty it is to be a CFC, the non-CFC situation carries its own particular level of nastiness. Some people actually enthusiastically try to become CFCs. This may be more of an issue if this legislation passes. You do have current income, but you also get the current inclusion of the foreign tax credit, which can sometimes be a good trade-off. This can happen even though you own less than 50% of the foreign subsidiary by vote. Many countries that limit your ownership of voting control do allow you to own more than 50% by value. So you can become a CFC and get the good answer on the foreign tax credits, if you own more than 50% by value, and even though you don't earn more than 50% by vote.

There are also a few other things you can do. You can form partnerships, and you can do a second class of voting stock. Another way you can do it is to own a few shares of your joint venture partner. If you're 50/50 and you own a little bit of the joint venture partner, the way the strange counting goes, you can suddenly be at 50.01, and that could be good news. It can also be a big surprise for companies when they find out that what they thought was a 50/50 venture, and not CFC, is now the bigger 50 and it is a CFC. So that could be good news or bad news, depending on what you're trying to do.

There's a concept in Latin America called the user front, which is a right to dividends. There are tax consequences of the user front, which is a civil law concept having no parallel in the U.S., except in Louisiana, which has a civil law heritage.