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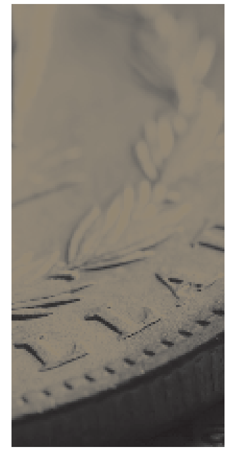
FOREIGN INSURANCE SUBSIDIARIES' RESERVE AMOUNTS MAY BE USED TO DETERMINE FOREIGN PERSONAL HOLDING COMPANY INCOME



By Kevin M. Owens

In PLR 201151008, the Internal Revenue Service (the "Service") has ruled that the loss reserves (claim reserves) and underwriting reserves that are held by foreign subsidiaries for life insurance and annuity contracts and are required to be filed with the life insurance regulators of the relevant foreign country are an appropriate means of measuring income under section 954(i)(4). Accordingly, these reserve amounts may be used in determining the company's foreign personal holding company income under section 954. The private letter ruling provides some technical guidance on what foreign financial statement reserves the Service may consider to be appropriate for determining subpart F income and follows prior rulings that the Service has issued.[1] More importantly, the private letter ruling highlights an area on which insurance companies may not have focused. In recent years, U.S. insurance companies and other U.S. investors have invested in foreign insurance markets by acquiring interests in foreign insurance companies. Frequently, the foreign insurance companies qualify as controlled foreign corporations (CFCs). The U.S. shareholders of these CFCs must annually determine the subpart F income and the earnings and profits of the CFC.

BACKGROUND

In general, section 951(a) of the Internal Revenue Code (the "Code") requires that a U.S. shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income for each year. In the case of a CFC's insurance business, subpart F income will generally include section 953 "insurance income" and section 954 foreign base company income, specifically, "foreign personal holding company income" as defined in section 954(c)(1). Section 953(a) broadly defines subpart F insurance as any income which is attributable to issuing (or reinsuring) of an insurance or annuity contract, and which would be taxed under subchapter L if the income were the income of a domestic insurance company. However, subpart F insurance income does not include "exempt insurance income" defined in section 953(e). Generally, the rules of subchapter L are used to determine section 953(a) insurance income. One exception is that reserves for any insurance or annuity contract are determined in the same manner as under section 954(i).

Generally, section 954 foreign personal holding company income includes the investment income of an insurance business, *e.g.,* dividends, interest, royalties, rents, gains and losses from the sale or exchange or property, net gains from commodity transactions and net foreign currency gains. However, foreign personal holding company income does not include "qualified insurance income" of a "qualifying insurance company." "Qualified insurance income" is income from an unrelated person that is derived from investments by a "qualifying insurance company" or a "qualifying insurance company branch" of its reserves or 80 percent of unearned premiums allocable to exempt contracts, and one-third of premiums earned for property, casualty or health insurance contracts and 10 percent of the reserves for life insurance or annuity contracts. Qualifying insurance company and qualifying insurance company branch are defined in section 953(e). A critical component of section 953 insurance income and section 954 foreign personal holding company income, therefore, is the amount of insurance reserves determined under section 954(i).

Under section 954(i)(4)(B), the amount of the reserve for any life insurance or annuity contract is the greater of the net surrender value of the contract, as defined in section 807(e)(1)(A), or the reserve determined under section 954(i)(5). Under section 954(i)(5), the amount of the reserve is "determined in the same manner" as it would be determined if the qualifying

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insurance company were subject to tax under subchapter L, with specific rules for interest rates and mortality and morbidity tables. The applicable federal interest rate is replaced with an interest rate determined for the functional currency of the qualifying insurance company's home country, calculated (except as provided by the Treasury Secretary in order to address insufficient data and similar problems) in the same manner as the mid-term applicable federal interest rate (AFR (within the meaning of section 1274(d)). The prevailing state assumed rate is replaced with the highest assumed interest rate permitted to be used for purposes of determining statement reserves in the foreign country for the contract. Mortality and morbidity tables that reasonably reflect the current mortality and morbidity risks in the foreign country are used in lieu of U.S. mortality and morbidity tables.

In certain instances, a CFC can use its foreign statement reserves for purposes of determining its reserve for life insurance or annuity contracts. The CFC must obtain a ruling from the Service that the factors taken into account in determining the foreign statement reserve (less any catastrophe, deficiency, equalization, or similar reserves) provide an appropriate means of measuring income; the amount of the reserve is the foreign statement reserve. The Service's approval is based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for federal income tax purposes. The CFC is required to provide the Service with information as to the method, interest rate, mortality and morbidity assumptions, and other assumptions under the foreign reserve rules so that a comparison can be made to the reserve amount determined by applying the tax reserve method that would apply if the qualifying insurance company were subject to tax under subchapter L.[2]

FACTS AND CONCLUSION OF THE RULING

Parent engages in the insurance business both domestically and internationally through its subsidiaries. Parent, through a wholly owned U.S. subsidiary, holds all the stock of insurance subsidiaries operating in foreign countries, "the CFCs," which all operate in Country A. Country A government agency (the Agency) regulates the insurance industry in that country. The CFCs file annual reports and financial statements with the Agency that are audited by outside auditors, are subject to inspection by the Agency, and are made available to the public. The CFCs use these reports for financial, as well as regulatory, purposes. In accordance with Country A's rules for life insurance companies, the CFCs each set forth on their license application the computation method for their underwriting reserves, which must conform to the standards prescribed by the Agency. Any change to the method requires advance notice to the Agency. Country A's laws also require the CFCs to establish and maintain certain reserves (underwriting reserves and loss reserves) for obligations to holders of their life insurance and annuity contracts and to set forth the amount of such reserves on the annual reports. The Agency requires the CFCs to hold underwriting reserves to secure the performance of obligations arising in the future from the life insurance and annuity contracts. The CFCs are also required by the Agency to maintain loss reserves for outstanding claims (including incurred but not reported claims) under life insurance and annuity contracts. The CFCs calculate loss reserves using the company's individual experience, in accordance with the Agency's rules. In compliance with Country A's rules, the CFCs have each appointed a qualified actuary to be involved in any actuarial matters, including the method of calculating reserves. The actuary is required to submit reports to the board of directors and to the Agency on the actuarial soundness of the CFCs' reserves.

In concluding that the underwriting reserves used in the foreign statements of the CFCs can be used to determine subpart F income under section 954(i)(4)(B)(ii), the Service cited the following reasons:

1. The CFCs must establish, maintain and calculate their underwriting reserves in accordance with the insurance laws and regulations of Country A and guidance prescribed by the Agency.
2. The Agency generally requires a life insurance company to determine the amount of its underwriting reserves under the net level premium method. The Agency allows the CFCs to calculate their underwriting reserves under the Zillmer method provided they also maintain special risk reserves for mortality and investment risk. The CFCs hold reserves under the net level premium method and the Zillmer method. The Zillmer reserve and the special risk reserves required by the Agency when the Zillmer method is used are less than the underwriting reserve that would need to be maintained if they were determined under the net level premium method.[3]

3. The CFCs must set forth their underwriting reserves on the Annual Reports, which must be filed annually with the Agency. As such, these reserves are the measure of the legal obligations to contractholders on the financial statement used for regulatory purposes by life insurance companies doing business in Country A.
4. The Agency requires the CFCs to hold their underwriting reserves to enable them to fulfill claims owed to contractholders and their beneficiaries.
5. The underwriting and risk reserves are not catastrophe, deficiency, equalization, or similar reserves.

The Service also determined that the loss reserves held by the CFCs , *i.e.,* losses payable, are foreign statement reserves within the meaning of section 954(i)(4)(B)(ii), for the following reasons:

1. The CFCs must establish, maintain and calculate loss reserves in accordance with the insurance laws and regulations of Country A and guidance issued by the Agency.
2. The CFCs must set forth their loss reserves on the Annual Reports, which must be filed annually with the Agency. As such, they are the measure of the legal obligations to the contractholders on the financial statement used for regulatory purposes by life insurance companies doing business in Country A generally (whether U.S.-owned, locally owned, or owned by companies headquartered in other foreign countries).
3. The Agency requires the CFCs to hold loss reserves for the fulfillment of the claims of contractholders and their beneficiaries.
4. The CFCs' loss reserves are not catastrophe, deficiency, equalization, or similar reserves.

The Service noted that it was not expressing an opinion regarding whether some or all of the risk reserves would constitute foreign statement reserves within the meaning of section 954(i)(4)(B)(ii) when the risk reserves cause total underwriting reserves to exceed the standard valuation reserve using the reserve method prescribed by the Agency. The Service also noted that the rulings are solely that certain foreign reserves are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) and for no other purpose.

IMPLICATIONS OF THE RULING

Reserves as determined under section 954(i) are a critical component of subpart F income of a CFC that is engaged in the insurance business. For a variety of reasons, CFCs may not focus on the determination of reserves as required by section 954(i). As investments in foreign insurance operations continue to grow and become more significant to the investor, the need for accurately determining subpart F income becomes more important. Also, the taxation of actual or deemed distributions is dependent on accurately determining subpart F income and earnings and profits.

There are two basic methods of determining reserves under section 954(i): (1) recalculate the reserves of the CFC in accordance with the rules as laid in section 954(i)(4), or (2) obtain approval from the Service via a private letter ruling to use the CFC's local statutory reserves. Recalculation of the reserves requires a substantial amount of work and typically results in a reserve that is lower than the reserve used on the financial statements of the CFC. While no prior approval from the Service is required, the recalculation of the reserves is subject to examination by the Service at a later date. Obtaining the Service's approval to use financial statement reserves requires substantial correspondence with the Service. While the Service pre-approves the use of the financial statement reserves, the correspondence with the Service and factual basis for the approval of the Service may be subject to examination.

In order to determine reserves under section 954(i) or for earnings and profits purposes, a taxpayer must have extensive actuarial expertise and knowledge of the section 807 reserving requirements and a thorough understanding of the insurance products being sold by the CFC, the business and accounting processes used by the CFC in accounting for those products, and how the products are regulated and taxed by the local authorities.

The views expressed are those of the author and not of Ernst & Young LLP.

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END NOTES

[1] *See* PLRs 200327052, 200341019 and 200709049.
[2] *See* Staff of the Joint Comm. on Taxation, Technical Explanation of the "Job Creation and Worker Assistance Act of 2002" (JCX-12-02 (March 6, 2002)).
[3] Broadly speaking, a "Zillmer" reserve method is a "modified" net premium reserve with an allowance for expenses in the net premium. The Commissioners Reserve Valuation Method (CRVM) is a form of "Zillmer" reserve. Outside of the United States, preliminary term reserves are often referred to as "Zillmerized reserves."