SOCIETY OF ACTUARIES

Article from

Taxing Times

June 2016
Issue 12
Volume 2

In the Beginning … A Column Devoted to Tax Basics
Taxation of U.S. Owned Foreign Insurance Operations

By Tim Branch

Many U.S. insurance companies have wholly-owned foreign insurance company subsidiaries or branches, and this article is intended to highlight some of the important tax issues related to such foreign insurance operations. The treatment of foreign operations for U.S. tax purposes is complex, and the addition of the insurance component adds to the complexity. This article won't be able to cover all the tax aspects of foreign insurance operations, but will hopefully give the reader an idea of their general treatment for U.S. tax purposes.

Generally, foreign insurance operations of U.S. companies are either branches or Controlled Foreign Corporations ("CFCs"). There are other forms that foreign insurance operation can take, but we'll focus our discussion on the treatment of CFCs in this article. CFCs are generally defined in Code section 957 as a foreign corporation that is more than 50 percent owned by U.S. shareholders[1] (either on a voting power or stock value basis). The "more than 50 percent" test is replaced by "more than 25 percent" in case of certain foreign insurance companies.[2]

U.S. taxation of foreign owned enterprises, not just insurance operations, is addressed in Subpart F of the Code, which encompasses IRC sections 951 through 965. These sections tell U.S. taxpayers what amounts of U.S. taxable income to include from CFCs, and are intended to address the issue of deferring U.S. taxation on foreign income. Generally, U.S. tax on income from a foreign operation is deferred until it is repatriated to the U.S. parent company. By keeping income in a foreign country, presumably with a lower tax rate than the U.S., a company can defer including the income in their U.S. tax return. Subpart F was enacted in 1962 to prevent U.S. taxpayers from abusing this deferral by requiring current taxation of certain income earned in a CFC.

Subpart F requires U.S. shareholders of CFCs to include certain items in current taxable income, even if the items have not been distributed or repatriated by the CFC. These Subpart F income items include income that has little or no relation to the CFC's country of incorporation, and can be easily moved to another country, such as investment earnings ("passive income"). Subpart F also contains exceptions that are intended to carve out

income items that cannot be easily moved and are related to the CFC's home country, such as production of goods or services. So how do insurance operations fit into the context of Subpart F?

Subpart F income[3] includes two main items; 1) insurance income,[4] and 2) foreign base company income[5] (FBCI). The FBCI item includes many components, some of which are industry-specific (such as oil-related activities) and others which are more widely applicable such as foreign personal holding company income (FPHCI) and foreign base company sales and services income. We'll look at each of the two main Subpart F income items in greater detail below.

Insurance income, for purposes of Subpart F, includes "any income which (A) is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and (B) would… be taxed under Subchapter L of this chapter if such income were the income of a domestic insurance company," subject to certain modifications to Subchapter L. These modifications include eliminating the "small life insurance company" deduction under IRC section 806, and the determination of reserves under IRC section 954(i) which we will discuss later in this article.

There is also a very important exception to the Subpart F definition of insurance income for exempt insurance income[6] (EII), which is income derived from exempt contracts (as defined in the following sentence) issued by a qualifying insurance company. Very broadly, EII is income derived from life and annuity insurance contracts issued to residents of the CFC's country of domicile (which constitute "exempt contracts") by an insurance company that primarily writes business in that country, but would otherwise qualify as a Subchapter L company in the U.S. If a contract is regulated as a life insurance contract or annuity contract in the CFC's home country, its determination as a life or annuity contract for purposes of sections 953 and 954 can be made without regard to 72(s), 101(f), 817(h), and 7702. The EII provision typically eliminates most of an insurance CFC's Subpart F income from operations, assuming it is primarily operating and insuring risks in its home country.

As mentioned above, FPHCI is a component of FBCI and includes dividends, interest, royalties and rents. So how does this apply to the investment income associated with assets supporting the CFC's insurance reserves? IRC section 954(i)(2) provides special rules for applying the provisions of the FPHCI under IRC section 954(c)(1), whereby qualified insurance income (QII) is excluded from the FPHCI calculation. QII is defined as income of a qualifying insurance company which is received from an unrelated party and derived from the investments supporting up to 110 percent of the reserves described under IRC section 954(i)(4) for life insurance and annuity contracts (or 80 percent of unearned premium, plus discounted loss reserves, plus one-third of premiums earned during the taxable year for property, casualty or health contracts). Interest earnings in excess of these amounts are included in Subpart F income. Essentially, this exception allows an insurance company to earn the investment income necessary to support the reserves related to its exempt contracts without requiring it to be reported as Subpart F income; investment earnings in excess of what is needed to support the reserves is included in Subpart F income.

IRS section 954(i)(4) defines the methods for determining unearned premium and reserves for purposes of determining EII under IRC section 953(e) and QII under IRC section 954(i)(2). We'll focus on IRC section 954(i)(4)(B) which defines reserves for life insurance and annuity contracts. In general, this section states that reserves are the greater of the contract's net surrender value (as defined in IRC section 807(e)(1)(A)) or the reserve determined in the same manner as it would be if the CFC was subject to Subchapter L with modifications to the interest and mortality assumed. This means the CFC's reserves would need to be recalculated under the CRVM for life insurance contracts or the CARVM for annuity contracts, which was in effect at the issuance of the contract.

The interest rate used in the calculation of the IRC section 954(i) reserve is determined in the same manner as the interest rate used in the Subchapter L calculation (the greater of the applicable Federal interest rate (AFIR) or the prevailing State assumed interest rate (PSAIR)), except the AFIR is replaced by the interest rate for the functional currency of the CFC which is calculated in the same manner as the Federal mid-term rate under IRC section 1274(d), and the PSAIR is replaced by the highest assumed interest rate permitted to be used in determining the foreign statement reserves[7]. This adjustment is to recognize that the CFC is investing in its local capital markets and not necessarily in U.S. investments.

The mortality and morbidity rates used in the calculation of the IRC section 954(i) reserve should "reasonably reflect the current mortality and morbidity risks in the company's or branch's home country,"[8] instead of the Commissioners' Standard Ordinary table or other tables prescribed for use in the U.S.

Alternatively, the CFC could submit a ruling request to the IRS to use its foreign statement (i.e., local regulatory) reserves (less any catastrophe, deficiency, equalization, or similar reserves) in lieu of recalculating its reserves on a modified Subchapter L basis.[9] In order to receive a favorable ruling for such a request, the taxpayer must demonstrate that the foreign statement reserves "provide an appropriate means of measuring income."[10] The foreign statement reserves would still be subject to the net surrender value floor.

Obviously, the recalculation of reserves on a modified Subchapter L basis presents administrative and technical difficulties. Administratively, the CFC or U.S. parent company will need to maintain, at a minimum, two sets of reserves—one set for foreign regulatory purposes and another set on the modified U.S. tax basis. This can present a challenge for either the foreign or U.S. actuary who has to learn a new reserve regime and correctly code it into a valuation system. Recalculating reserves under a Subchapter L basis can also raise many technical questions which are not addressed in IRS guidance; what does it mean that an interest rate is calculated in the same manner as the federal mid-term rate? Is this interest rate used in the reserve calculation, or is it meant to be the 60 month average of such rates, similar to the AFIR? How are foreign insurance products classified under the U.S. statutory regime? What mortality or morbidity table reasonably reflects local country risks?

Alternatively, U.S. insurance companies may make an election under IRC Section 953(d) to treat a CFC as a domestic corporation, if the CFC meets certain conditions, and reserves would be calculated under Subchapter L without modifications. This election avoids the complexities of the Subpart F treatment described above, and is often made for foreign operations that would not otherwise benefit from deferral of income (i.e., little or no EII or QII).

There are many other details, nuances, cross-references and exceptions contained in Subpart F. This article is merely intended to give a brief overview of some of the issues to consider when dealing with foreign insurance subsidiaries and operation.

Taxation of foreign operations is a complex and much debated area of current tax practice. However, the general idea behind Subpart F is pretty simple; income that is relocated abroad for the sole purpose of avoiding current U.S. taxes should be taxed under Subpart F, and exceptions are made for foreign income that is actively earned and not moved abroad to avoid current U.S. tax. These exceptions to Subpart F, in particular certain foreign insurance company income, are not taxed until the income is repatriated to the U.S. However, we all know the devil is in the details, and Subpart F is full of details so be careful when considering how to handle foreign insurance subsidiaries! ■

Tim Branch, FSA, MAAA, is a 2nd vice president of the Phoenix Life Insurance Company, working in the life modeling area. Prior to joining Phoenix, he was a consultant specializing in company tax issues, and has also worked in the tax department of a large multi-line insurer and may be reached at *tim.branch@phoenixwm.com*.

END NOTES

[1] IRC section 951(b) defines a United States shareholder as “a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.”

[2] There are special rules that apply to certain captive insurance companies under IRC section 953(c), such as the “Related person insurance income” rules, which are beyond the scope of this article.

[3] IRC section 952

[4] IRC section 953

[5] IRC section 954

[6] IRC section 953(e)

[7] IRC sections 954(i)(5)(A) and 954(i)(5)(B)

[8] IRC section 954(i)(5)(C)

[9] This is essentially the same treatment as foreign branches of domestic life insurance companies, provided the foreign country is non-contiguous to the U.S., are allowed to use under IRC section 807(e)(4), with the additional requirement that the reserves do not exceed the net level reserves.

[10] IRC section954(i)(4)(B)(ii)