

Financial Services - Insurance Tax Bulletin

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Reserve amount calculation for foreign report purposes is an acceptable method to measure insurers' foreign personal holding company income

In PLR 201151008 the IRS said underwriting reserves and loss reserves for life insurance and annuity contracts, required to be maintained by controlled foreign corporations in annual financial statement reporting to a foreign regulatory agency, are an appropriate means of measuring income within the meaning of Section 954(i)(4)(B)(ii) and, accordingly, are the amount of reserves that may be used in determining each company's foreign personal holding company income under Section 954.

Parent is a publicly-traded domestic corporation that is engaged, through its many subsidiaries, in various lines of business, which primarily include domestic life insurance, asset management, and international life insurance. Parent owns all the stock of US Sub. US Sub directly and indirectly owns all the stock of CFC1, CFC2, and CFC3. CFC1, CFC2, and CFC3 are controlled foreign corporation as defined in section 957. US Sub also owns the stock of other foreign corporations engaged in the life insurance business in other foreign countries and certain assets and liabilities related to the international insurance business.

CFC1, CFC2, CFC3 are licensed to sell life insurance and annuity contracts to residents of Country A. The entities each derive more than 50 percent of its aggregate net written premiums from issuance of life insurance and annuity contracts covering risks in connection with the lives or health of residents of Country A. Neither CFC1, CFC2, nor CFC3 carries on non-life insurance businesses other than incidental businesses.

In compliance with required rules for life insurance companies conducting business in Country A, CFC1, CFC2, CFC3 each set forth the computation method for its

underwriting reserves on its license application. The computation method must be based on an actuarial calculation, must be reasonable and appropriate, and must conform to any other prescribed standards.

CFC1, CFC2, CFC3 must establish and maintain certain reserves including: (1) underwriting reserves (including reserves for variable contracts) and (2) loss reserves, and must set forth the amount of such reserves on the

All insurance laws and regulations of Country A are regulated by a government agency (the Agency). Life insurance reserves must be determined as follows: (1) the prescribed reserve method for life insurance is the net level premium ("NLP") method; (2) the prescribed mortality table is the standard mortality table generated by the institute of actuaries of Country A; and (3) the prescribed standard interest rate assumption is based on 10-year government bonds of Country A.

The Agency requires fixed annuity reserves to be determined using the same assumptions as life insurance reserves except that a different mortality table is prescribed. The total of amounts credited to the separate accounts for policyholders must be held as premium reserves.

Although the NLP reserve method is the Agency-prescribed reserve method, the Agency has granted CFC1, CFC2, and CFC3 approval to use the 5-year Zillmer method to calculate its standard valuation reserve for a period of time before reaching NLP reserves. When the 5-year Zillmer method is used, CFC1's, CFC2's and CFC3's standard valuation reserves may be less than those reserves would be under the NLP reserve method. As a result, in such a case, the Agency also requires CFC1, CFC2, and CFC3 to maintain additional risk reserves.

The risk reserves are comprised of a mortality risk reserve and an interest rate assumption risk reserve. Risk reserve for ordinary death risk is generally equal to .6 per 1000 net amount at risk under the policy. The interest rate assumption risk reserve is calculated as the sum of (i) a factor, depending on the interest rate assumption, times the standard valuation reserve (for current issues, the factor is .01) and (ii) 3 percent of the standard valuation reserve.

CFC1, CFC2, and CFC3 each holds reserves determined under the NLP method. CFC1 and CFC3 also hold some reserves determined under the Zillmer method as well as special risk reserves. The Zillmer reserve and special risk reserves of CFC1 and CFC3 are less than the underwriting reserve that would need to be maintained if CFC1 or CFC3 determined such reserves under the NLP method.

Currently, the total underwriting reserves held by CFC1, CFC2, and CFC3 for life insurance and fixed annuity contracts are less than the standard valuation reserves would be for such contracts if calculated using the NLP method. Loss reserves must be held for outstanding claims under life insurance and annuity contracts issued by CFC1, CFC2, and CFC3 in Country A. CFC1, CFC2, and CFC3 calculate the reserves using the company's individual loss experience.

CFC1, CFC2, and CFC3 have each appointed a qualified actuary to be involved in matters prescribed by the Agency as actuarial matters, specifically including the method of calculating reserves. The actuary must have necessary knowledge and experience concerning actuarial matters and must meet requirements prescribed by

the Agency. The actuary is required to submit a written opinion to the Board of Directors of the company and to the Agency concerning whether or not the reserves relating to the insurance contracts prescribed by the Agency are established and maintained in accordance with actuarial soundness.

Parent and some subsidiaries have requested a ruling that the underwriting reserves and loss reserves, which are required to be maintained by CFC1, CFC2 and CFC3 for their life insurance and annuity contracts on Annual Reports, are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) and, accordingly, are the amount of reserves that may be used in determining each company's foreign personal holding company income under section 954.

In general, under Sec. 951(a), a U.S. shareholder of a controlled foreign corporation ("CFC") must include in gross income its pro-rata share of the CFC's Subpart F income for each year. Subpart F income includes, among other types of income, foreign base company income. Sec. 952(a). Section 954(a)(1) defines the term "foreign base company income" to include, among other types of income, foreign personal holding company income. Section 954(c)(1) sets forth the types of income (e.g., interest and dividends) that are considered to be foreign personal holding company income. Sec. 954(c)(1)(A). Section 954(i)(1) provides that for purposes of section 954(c)(1), foreign personal holding company income does not include "qualified insurance income" of a "qualifying insurance company." Section 953(e)(3) defines the term "qualifying insurance company." Section 954(i)(2) defines the term "qualified insurance income" for purposes of this ruling.

CFC1, CFC2, and CFC3 are each subject to regulation as a life insurance company by Country A. Each is licensed, authorized, and regulated by the Agency. CFC1, CFC2, and CFC3 each represented that it derives more than 50 percent of its aggregate net written premiums from its issuance of life insurance and annuity contracts covering risks in connection with the lives or health of residents of Country A, and that no policyholder, insured, annuitant, or beneficiary is a related person (as defined in Code section 954(d)(3)). Finally, CFC1, CFC2 and CFC3 are engaged in the life insurance business and would be subject to tax under Subchapter L, if they were domestic corporations. Accordingly, CFC1, CFC2 and CFC3 are QICs.

Since CFC1, CFC2, and CFC3 issue life insurance and annuity contracts in connection with the lives and health of residents of Country A, and each derive more than 30 percent of its net written premiums from contracts that cover Country A risks with respect to no related persons within the meaning of section 954(d)(3), such contracts are exempt contracts within the meaning of section 953(e)(2).

The IRS determined that the underwriting reserves held by CFC1, CFC2, and CFC3 for their exempt contracts that are life insurance or annuity contracts are foreign statement reserves within the meaning of Code section 954(i)(4)(B)(ii). The IRS also determined that the loss reserves held by CFC1, CFC2, and CFC3 for their exempt contracts that are life insurance or annuity contracts are foreign statement reserves within the meaning of Code section 954(i)(4)(B)(ii).

The IRS concluded that under the facts, the underwriting reserves (including risk reserves) of CFC1, CFC2, and CFC3 for their exempt contracts that are life insurance or annuity contracts, as required to be calculated for purposes of the Annual Reports

filed with the Agency, are an appropriate means of measuring income within the meaning of section 954(1)(4)(B)(ii) and, accordingly, are the amount of these reserves that may be used in determining each company's foreign personal holding company income under section 954.

In addition, the IRS found that the loss reserves of CFC1, CFC2, and CFC3 for their exempt contracts that are life insurance or annuity contracts, as required to be calculated for purposes of the Annual Reports filed with the Agency, are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) and, accordingly, are the amount of reserves that may be used in determining each company's foreign personal holding company income under section 954.

For further information, please feel free to contact Anthony DiGilio at (703) 918-4812 or contact your local insurance tax professional.

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