

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Telephone Number:

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Date:

July 08, 2003

Parent =

IHC =

CFC =

State A =

Country A =

Agency =

Annual Report =

U =

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Dear :

We respond to your letter dated V, requesting a ruling that certain reserves held by a foreign subsidiary for life insurance contracts required to be set forth on the financial statements and filed with the life insurance regulator of Country A are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) of the Internal Revenue Code of 1986, as amended. (Hereinafter, all section references are to the Internal Revenue Code of 1986, as amended.)

The rulings given in this letter are based on facts and representations submitted by Parent and CFC and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the materials submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

### **Facts**

Parent is a publicly-traded domestic corporation that is engaged in various lines of business through its many subsidiaries, including the life insurance business. Parent owns all the stock of IHC, a State A holding corporation for Parent's life insurance subsidiaries operating in foreign countries. IHC owns all of the stock of CFC. CFC was formed under the laws of Country A and is engaged in the life insurance business in Country A. CFC is a controlled foreign corporation as defined in section 957.

Country A's Insurance Business Act, its enforcement decree, and its Regulation on Supervision of Insurance Business ("Regulations") regulate all material aspects of the insurance business in Country A, including capital requirements, licensing, product standards, management of insurers, asset management, insurance accounting (including calculation of reserves), the sale and solicitation of insurance contracts,

actuarial matters, etc. A government agency (the "Agency") is responsible for regulating insurance companies in Country A.

CFC is licensed by the Agency to sell life insurance to residents of Country A and to engage in the reinsurance business in Country A. CFC is subject to regulation by the Agency as a life insurance company. CFC derives more than 50 percent of its aggregate net written premiums from its issuance of life insurance, endowment, and variable life insurance contracts (and supplemental benefit riders) covering risks in connection with the lives or health of residents of Country A and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person as defined in section 954(e)(3). The life insurance contracts issued by CFC are regulated as life insurance contracts by the Agency. Parent has represented that CFC would be subject to tax under Subchapter L if it were a domestic corporation.

Under Country A's insurance laws and regulations: (i) CFC must file an annual report and financial statements, including an audit report, with the Agency ("Annual Report"); (ii) CFC must annually submit a written actuarial opinion regarding the adequacy of the calculation of policy reserves to the Agency; (iii) the Agency may appoint an independent actuary to determine the adequacy of the written actuarial opinion submitted; (iv) The Agency may examine CFC's books and records at any time; and (v) once established, no changes in the method of calculating reserves are allowed.

The audit report is prepared in accordance with the accounting rules applicable to the annual report and financial statements. DATE Y is the official year-end for life insurance companies operating in Country A.

Like all life insurance companies doing business in Country A, CFC is required by law to establish and maintain certain liabilities and reserves for its obligations to holders of its life insurance contracts and to set forth the amount of such obligations on the Annual Report. The reserves at issue in this request are (i) the premium reserve, (ii) the unearned premium reserve, (iii) the reserve for outstanding claims, (iv) the policyholders' dividend reserve, (v) the policyholders' profit dividend reserve, (vi) the policyholders' equity adjustment, (vii) premiums received in suspense, (viii) unearned insurance premium, and (ix) separate account credits. CFC accounts for these obligations in accordance with insurance regulations and rules of the Agency. They are calculated using the formula for computing premiums, insurance terms, and policy reserves approved by the Agency. Each category of obligation and the calculation of its amount are described in further detail below:

1. Premium Reserves. CFC must use the standard interest rate and standard risk (mortality) rate prescribed by the Agency in determining its premium reserves. Premium reserves include the obligations under the basic contract and any supplemental benefit riders, such as accidental death and disability. CFC's premium reserve, combined with the unearned premium reserve

described below, is determined using the net level premium reserve method (“NLP method”).

2. Unearned premium reserve. The unearned premium reserve is the amount of premium due whose applicable period has not yet arrived (i.e., it is the portion of the premium that is due and relates to a period not yet expired).
3. Reserve for outstanding claims. CFC also holds reserves for outstanding claims under its life insurance contracts. This includes claims determined but not yet paid, and disputed claims.
4. Policyholders’ dividend reserve. These reserves are for dividends that have been declared and that have been credited, or will be credited at the next policy anniversary date, to policyholders and that have not been withdrawn by policyholders.
5. Policyholders’ profit dividend reserve. Under Country A’s laws and regulations, 90% of profits earned attributable to participating policies are required to be credited to this reserve for payment to policyholders within 5 years, including appropriate adjustment for income or loss over the period until payment. The reserve reflects such dividends that are not yet reflected in the policyholders’ dividend reserve described above.
6. Policyholders’ equity adjustment. The basic reserve for variable life insurance contracts is held as part of the premium reserve and unearned premium reserve and is equal to the sum produced by the addition or subtraction of premiums and investment income (or loss) in the separate account. The policyholders’ equity adjustment reflects unrealized gains (or losses) on investment securities in separate accounts underlying variable life insurance contracts at year-end. The basic reserve combined with the policyholders’ equity adjustment reflects the obligations to policyholders under CFC’s variable life contracts.
7. Premiums received in suspense. This amount reflects premiums received from policyholders before the policies are issued.
8. Unearned insurance premium. This amount reflects premiums paid by policyholders before they are due.
9. Separate Account Credits. Premiums received for CFC’s variable life insurance contracts are recorded as general account receipts which are then allocated to the separate account forming the basis for the contracts. The separate account credits reflect amounts not yet allocated from the general account to the separate account. Such amounts reflect obligations to

policyholders under the contracts which are not yet reflected in the basic reserves for the contracts.

Parent and CFC have requested rulings that the above listed reserves and policyholder obligations (the "Reserves"), which are required to be maintained by CFC by the Agency for their life insurance contracts on its Annual Report, are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii) and, accordingly, are the amounts that may be used in determining the CFC's foreign personal holding company income under section 954.

## Law

In general, a United States 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. I.R.C. Sec. 951(a). 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 a “qualifying insurance company” as any controlled foreign corporation which:

(A) is subject to regulation as an insurance company by its home country, and is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance or annuity contracts to persons other than related persons (within the meaning of Code section 954(d)(3)) in such home country;

(B) derives more than 50 percent of its aggregate net written premiums from the issuance by such controlled foreign corporation of contracts covering applicable home country risks of such corporation and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in Code section 954(d)(3)); and

(C) is engaged in the insurance business and would be subject to tax under Subchapter L if it were a domestic corporation.

Section 953(e)(2)(B)(ii) defines the term “applicable home country risks” to include risks in connection with the lives or health of residents of the home country of the qualifying insurance company issuing the contract covering the risks.

Section 954(i)(2) defines the term “qualified insurance income” to mean income of a qualifying insurance company falling into either of two categories. First, income received from unrelated persons and derived from investments made by a qualifying insurance company or qualifying insurance company branch (collectively referred to as a “QIC”) of its reserves allocable to exempt contracts or of 80 percent of its unearned premiums from exempt contracts (as both are determined in accordance with section 954(i)(4)). Sec. 954(i)(2)(A). Second, income received from unrelated persons and derived from investments made by a QIC of an amount of its assets allocable to exempt contracts equal to: (1) in the case of property, casualty, or health insurance contracts, one-third of the premiums earned on those contracts during such year; and (2) in the

case of life insurance or annuity contracts, 10 percent of the reserves described in section 954(i)(2)(A) for such contracts. Sec. 954(i)(2)(B).

Exempt contracts are defined under section 953(e)(2) to include insurance or annuity contracts issued by a qualifying insurance company in connection with the lives or health of residents of a country other than the U.S., but only if such company derives more than 30 percent of its net written premiums from otherwise exempt contracts which cover applicable home country risks and with respect to which no policyholder, insured, annuitant or beneficiary is a related person within the meaning of section 954(d)(3).

Section 954(i)(4)(B)(i) generally provides that in the case of life insurance and annuity contracts, a QIC's reserves allocable to exempt contracts are equal to the greater of (1) the net surrender value of the contract, or (2) the reserve determined under section 954(i)(5). Section 954(i)(4)(B)(ii), however, provides:

The amount of the reserves under Code section 954(i)(4)(B)(i) shall be the foreign statement reserve for the contract (less any catastrophe, deficiency, equalization, or similar reserves), if, pursuant to a ruling request submitted by the taxpayer or as provided in published guidance, the Secretary determines that the factors taken into account in determining the foreign statement reserve provide an appropriate means of measuring income.

Code section 954(i)(4)(B)(ii) was enacted by section 614 of the Job Creation and Worker Assistance Act of 2002. The staff of the Joint Committee on Taxation explains this provision as follows:

The provision does, however, permit a taxpayer in certain circumstances, subject to approval by the IRS through the ruling process or in published guidance, to establish that the reserve for such contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be 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. In seeking a ruling, the taxpayer is required to provide the IRS with necessary and appropriate 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 of the Code (with the modifications provided under present law for purposes of these exceptions). The IRS also may issue published guidance indicating its approval.

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)).

### **Analysis**

CFC is subject to regulation as a life insurance company by Country A. CFC is licensed, authorized, and regulated by the Agency, which is the insurance regulatory body for Country A, to sell life insurance contracts to persons other than related persons (within the meaning of Code section 954(d)(3)) in Country A. CFC has 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 with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in Code section 954(d)(3)). Finally, CFC is engaged in the life insurance business and would be subject to tax under Subchapter L if it were a domestic corporation. Accordingly, CFC is a QIC.

CFC issues life insurance contracts in connection with the lives and health of residents of Country A, a country other than the U.S. Moreover, CFC derives more than 30 percent of its net written premiums from contracts that cover Country A risks with respect to which no policyholder, insured, annuitant or beneficiary is a related person within the meaning of section 954(d)(3). Therefore, such contracts are exempt contracts within the meaning of section 953(e)(2).

We have determined that the Reserves held by CFC for its exempt contracts are foreign statement reserves within the meaning of Code section 954(i)(4)(B)(ii), for the following reasons:

1. CFC must establish, maintain, and calculate its Reserves in accordance with the insurance laws and regulations of Country A and guidance prescribed by the Agency.
2. The Agency requires a life insurance company to determine the amount of its premium reserves under the NLP method.
3. CFC must set forth the Reserves on the Annual Reports, which must be filed annually with the Agency. As such, the Reserves are the measure of the legal obligations to policyholders 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).

4. Under these circumstances, the Reserves are not catastrophe, deficiency, equalization, or similar reserves.

### **Rulings**

Based on the information submitted, and the facts and representations made, we rule as follows:

1. CFC's premium reserves held for its exempt contracts that are life insurance, 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

2. CFC's unearned premium reserves held for its exempt contracts that are life insurance 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

3. CFC's reserves for outstanding claims held for its exempt contracts that are life insurance 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

4. CFC's policyholders' dividend reserves held for its exempt contracts that are life insurance 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

5. CFC's policyholders' profit dividend reserves held for its exempt contracts that are life insurance 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

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6. CFC's policyholders' equity adjustment reserves held for its exempt contracts that are life insurance 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, the amount of these reserves may be used in determining CFC's foreign personal holding company income under section 954.

7. CFC's premiums received in suspense for its exempt contracts that are life insurance 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, these amounts may be used in determining CFC's foreign personal holding company income under section 954.

8. CFC's unearned insurance premiums for its exempt contracts that are life insurance 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, these amounts may be used in determining CFC's foreign personal holding company income under section 954.

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9. CFC's separate account credits for its exempt contracts that are life insurance 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, these amounts may be used in determining CFC's foreign personal holding company income under section 954.

### **Caveats**

We express no opinion on any provisions of the Code or regulations not specifically covered by the above ruling.

### **Procedural Statements**

This ruling is directed only to Parent and certain of its subsidiaries. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

Parent should attach a copy of this ruling letter to its Federal income tax return for the taxable years to which this letter applies.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

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Steven D. Jensen  
Senior Counsel, Branch 5  
Office of Associate Chief Counsel  
(International)

cc: