

Internal Revenue Service

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Department of the Treasury
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Date:
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Legend

A =
Act =
CFC =
Country A =
Day X =
Day Y =
Designated Institute =

Insurance Rules =

Parent =
Regulator =

Sub 2 =
US Sub =
X % =
X Financial Year =
X Premium =
X Report =

Dear :

In a letter dated A, you requested rulings allowing CFC to use certain foreign statement insurance reserves in computing foreign personal holding company income under section 954 of the Internal Revenue Code on the grounds that these insurance reserves are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii).

The rulings contained in this letter are based upon information and representations submitted by Parent and accompanied by penalty of perjury statements executed by the appropriate parties. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Facts

Parent and US Sub represent the following:

Parent is a publicly-traded domestic corporation that is engaged, through its subsidiaries and affiliates, in various lines of business, which include life insurance. Parent is the common parent of an affiliated group of life insurance companies and non-life insurance companies that file a life/non-life consolidated federal income tax return under section 1504(c). Parent directly owns all the stock of US Sub, a domestic corporation that is part of Parent's U.S. federal consolidated group. US Sub owns X% of Sub 2, a Country A company taxable as a corporation for federal income tax purposes. The remainder is owned by an unrelated third party. Sub 2 wholly owns CFC. CFC is a controlled foreign corporation as defined in section 957(a). Both Parent and US Sub are U.S. shareholders of CFC within the meaning of section 951(b), and Parent is a controlling U.S. shareholder of CFC within the meaning of Treas. Reg. §1.964-1(c)(5). CFC is incorporated and domiciled in Country A and is engaged principally in the underwriting of life insurance contracts, annuity contracts, and accident and health contracts in Country A.

Country A's Act regulates nearly all aspects of the insurance business in Country A. The Act is developed and enforced by the Regulator. The Regulator is responsible for regulating insurance companies in Country A to persons other than related persons (within the meaning of section 954(d)(3)). To conduct an insurance business in Country A, an insurance company must obtain a license from the Regulator.

CFC is licensed by the Regulator to sell life insurance and annuity contracts to persons in Country A. Because CFC is licensed as a life insurer in Country A, it is prohibited from carrying on businesses other than life insurance and certain activities that are incidental to the life insurance business. CFC is not engaged in any insurance business outside of Country A.

CFC is subject to regulation by the Regulator as a life insurance company. CFC derives more than 50 percent of its aggregate net written premiums from the issuance of life insurance and annuity contracts covering risks in connection with the lives or health of residents of Country A. CFC derives more than 30 percent of its net written premiums from contracts that cover Country A risks. No policyholder, insured, annuitant, or beneficiary to a life insurance or annuity contract that CFC issues is a related person as defined in section 954(d)(3). CFC would be subject to tax under Part I of Subchapter L if it were a domestic corporation.

CFC issues contracts that are regulated as life insurance and annuity contracts by the Regulator. It also issues other contracts. CFC has a few contracts in connection with the life or health of a resident of the United States (as described under section 953(e)(2)(A)) or from a related party (as defined in section 953(c)(6)); however, the reserves related to these contracts are not covered by the requested rulings. Each contract covered by the requested rulings is (1) regulated as a life insurance or annuity contract by Country A; (2) a life insurance contract or an annuity contract for federal income tax purposes, as determined under section 953(e)(5), without regard to sections 72(s), 101(f), 817(h), and 7702; and (3) regulated as a life insurance or annuity contract by the Regulator. In addition, no policyholder, insured, annuitant, or beneficiary with respect to any contract covered by the requested rulings is a United States person.

Except with respect to separate account-type investment-linked life insurance and annuity contracts, underwriting reserves consist of the present value of future benefits plus future expenses, minus the present value of future gross (contract) premiums, all under reasonably current interest, mortality, morbidity, and lapse assumptions, with provision for moderate adverse deviation.

Loss reserves are reserves for outstanding claims (including claims that have been incurred but not reported) from life insurance and annuity contracts issued by CFC. CFC calculates the loss reserves using the company's individual loss experience, in accordance with the rules and regulations prescribed for these reserves by the Regulator.

CFC has policyholders' dividend reserves and premiums paid in advance reserves, both of which are calculated the same under the Country A reserve method as under sections 807(c)(4) and (5), respectively. CFC's other reserves related to policyholders' dividends are not included in the requested rulings, including policyholders' profit dividend reserves, policyholder dividend reserves representing accrued dividends that will be actually paid in a subsequent year, and reserves for dividends that will be credited either at the next policy anniversary date or at another future date. Only reserves for dividends that (1) have been declared, (2) credited to policyholders, and (3) have not been withdrawn by policyholders are included.

CFC also issues separate account-type investment-linked life insurance and annuity contracts, which are separately identified and maintained, and are supported by separately identifiable pools of assets. CFC is required to, and does, maintain and account for the assets relating to a separate account-type contract separately from its general assets (and segregate the assets supporting separate account-type contracts from general creditors of the company) pursuant to the Insurance Rules. The assets in the pools are marked to market for local regulatory reporting purposes and the associated reserve follows movements in the value of the assets (with very limited exceptions, such as surrender charges). The separate account-type contracts would be variable contracts as defined in section 817(d), except that they are segregated under Country A's laws or regulations. The separate account-type contracts do not have policyholders' dividend reserves associated with them.

As required by Country A's Insurance Rules, CFC files an annual report, financial statements, and an annual X Report with the Regulator. The X Report must cover all business relating to the life insurance and annuity contracts for all years of account and include the valuation methodology and the valuation assumptions, as well as certain other information. The annual report contains the reserves for life insurance and annuity contracts, is audited by external accounting auditors, and is required to be filed with the Regulator. The accounting records of CFC that form the basis for preparing the annual report are subject to inspection by the Regulator at any time. The annual report is made available to the public. The annual report is also used for financial purposes, such as Country A credit rating, by lenders, and by the public. As of its X Financial Year, CFC's year end is Day X.

In accordance with Country A's Insurance Rules, CFC has appointed a qualified actuary to be involved in matters designated by the Regulator as actuarial matters, including the application of appropriate method of reserve calculation and the preparation of the X Report. The qualified actuary must have knowledge and experience concerning actuarial matters, hold a fellowship in a Designated Institute, and meet the requirements prescribed by the Regulator. The qualified actuary is required to certify to the Regulator that the reserves relating to the insurance contracts prescribed by the Regulator are established and maintained in accordance with actuarial soundness, in addition to preparing the X Report.

The Insurance Rules require Country A insurance companies to target a minimum level of capital to ensure that each insurer maintains a capital adequacy level that is commensurate with its risk profile at all times. Country A's Insurance Rules generally require a company to develop a risk-based capital based on a static factor model using a rules-based approach.

To comply with Country A's insurance laws, CFC must establish and maintain reserves for its obligations to holders of its life insurance and annuity contracts and must report the amount of those reserves on the Country A annual report. The reserves at issue in

the requested rulings are limited to certain underwriting reserves, loss reserves, policyholders' dividend reserves, and premiums paid in advance reserves. The Act and the Insurance Rules prescribe rules for calculating these reserves. These 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 (whether U.S.-owned, locally-owned, or owned by companies headquartered in other foreign countries). The Regulator requires CFC to hold these reserves to enable it to fulfill claims owed to policyholders and beneficiaries.

The reserves covered by the requested rulings do not include: (1) reserves for contracts not covered by the requested rulings, including reserves allocable to accident and health insurance (including guaranteed renewable, noncancellable, or cancellable), contracts that are not life insurance contracts or annuity contracts for federal income tax purposes, contracts that are not exempt contracts, and contracts with respect to which a policyholder, insured, annuitant, or beneficiary is a United States person; (2) catastrophe, deficiency, equalization, or similar reserves; (3) contingency reserves and stabilization reserves; (4) excess interest reserves for excess interest credited beyond the end of the taxable year, reserves for accrued claims, policyholders' profit dividend reserves, the component of the policyholders' dividend reserves representing accrued dividends that will be actually paid in a subsequent year and dividends that will be credited or paid either at the next policy anniversary date or another future date, and reserves for policyholder dividend liabilities; (5) a reserve for any amount to protect against a future decline in value of the investment assets; (6) any reserves for accrued liabilities that for the accrual method meet the "all events test" (as described in Treas. Reg. §1.446-1(c)(1)(ii)) or for amounts capitalized under section 848; (7) loss reserves for unaccrued claims; (8) reserves related to X Premium – a Country A government protection scheme in the event of an insurer member failure; (9) any investment-linked capital guarantee expense reserves, including the excess reserve on capital guaranteed product; (10) expense runoff reserves and expense overrun reserves; (11) unexpired risk reserves; (12) revival policies reserves; (13) reserves related to riders that are personal accident and medical and health or otherwise not treated as life insurance reserves under section 816(b); and (14) any other reserves not specifically included.

Law

In general, a United States shareholder of a controlled foreign corporation must include in gross income its pro rata share of the controlled foreign corporation's Subpart F income for each year. Subpart F income includes, among other types of income, insurance income under section 953 and foreign base company income under section 954.

Section 953(a)(1) defines the term "insurance income" to include any income that is attributable to the issuing (or reinsuring) of an insurance or annuity contract, and that would be taxed under Subchapter L if such income were the income of a domestic

insurance company. Section 953(a)(2) provides that section 953 insurance income does not include “exempt insurance income” derived by a “qualifying insurance company.” Section 953(b)(3) provides that reserves for any insurance or annuity contract are determined in the same manner as under section 954(i).

Section 953(e)(1) defines “exempt insurance income” as income derived by a qualifying insurance company that is attributable to the issuing (or reinsuring) of an “exempt contract” by such company and that is treated as earned by such company in its home country for purposes of such country’s tax laws. An “exempt contract” is defined under section 953(e)(2) to include an insurance or annuity contract issued by a qualifying insurance company in connection with the lives or health of residents of a country other than the United States, 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).

In general, section 953(e)(3) defines a “qualifying insurance company” as any controlled foreign corporation that:

- 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 section 954(d)(3)) in such home country;
- 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 section 954(d)(3)); and
- is engaged in the insurance business and would be subject to tax under Subchapter L if it were a domestic corporation.

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 that are considered foreign personal holding company income. 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 954(i)(2) defines the term “qualified insurance income” to mean income of a qualifying insurance company falling into two categories. The first category is 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”) either 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)). The second category is 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.

Section 817 generally provides special rules for certain variable contracts for purposes of Part I of Subchapter L of the Code. Section 817(d) defines a “variable contract” as any contract that (1) provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to state law, is segregated from the general asset accounts of the company and (2) either provides for the payment of annuities, is a life insurance contract, or provides funding for insurance on retired lives.

If a contract satisfies the variable contract requirements, and the separate account that funds the variable contract is treated as a segregated asset account, section 817 requires that certain adjustments be made to the insurance company’s asset basis and insurance tax reserves with respect to the segregated asset account. Section 817(a) provides that, with respect to any variable contract, reserves are adjusted (1) by subtracting an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for by reason of appreciation in value of assets (whether or not the assets have been disposed of) and (2) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets.

Under section 817(b), the basis of each asset in a segregated asset account is increased or decreased by the amount of appreciation or depreciation, respectively, to the extent the reserves or other items referred to in section 817(a) are adjusted. The asset basis and insurance tax reserve adjustments offset any realized gain/loss attributable to such marked assets at the insurance company level.

Section 954(i)(3) imposes separate contract treatment for “separate account-type contracts,” a term which includes contracts not meeting the requirements of section 817. Section 954(i)(3)(A) provides that, for purposes of applying section 954(i) and with respect to any separate account-type contract (including any variable contract not meeting the requirements of section 817), income credited under such contract is allocable only to such contract. Income not allocable to a separate account-type contract is allocated ratably among the non-separate account-type contracts.

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 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.

Section 954(i)(4)(B)(ii) was originally enacted by section 614 of the Job Creation and Worker Assistance Act of 2002. Under the Protecting Americans from Tax Hikes (PATH) Act of 2015 (P.L. 114-113, 12/18/2015), section 954(i) was permanently extended and made effective for taxable years of foreign corporations beginning after December 31, 2014, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end. In its Technical Explanation to the PATH Act, the staff of the Joint Committee on Taxation explains section 954(i)(4)(B)(ii) 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.

Joint Comm. on Taxation, Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40) (JCX-144-15 (Dec. 17, 2015)).

Analysis

CFC is subject to regulation as a life insurance company by Country A. CFC is licensed, authorized, and regulated by the Regulator, which is the insurance regulatory body for Country A, to sell life insurance and annuity contracts to persons other than related persons (within the meaning of section 954(d)(3)) in Country A. Parent has represented that CFC derives more than 50 percent of its aggregate net written premiums from the issuance of life insurance and annuity contracts covering applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section 954(d)(3)). Finally, Parent has represented that 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 qualified insurance company under section 953(e)(3).

CFC issues life insurance and annuity contracts in connection with the lives and health of residents of Country A, a country other than the United States. No policyholder, insured, annuitant, or beneficiary with respect to any life insurance or annuity contract issued by CFC that is covered by the requested rulings is a United States person. 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). The contracts that are the subject of the requested rulings, therefore, are exempt contracts within the meaning of section 953(e)(2).

CFC must establish, maintain, and calculate its reserves (including each of the reserves covered by the requested rulings) in accordance with the Insurance Rules prescribed by the Regulator. The Regulator requires a life insurance company to determine the amount of its reserves based on guidance provided by the Regulator. These 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 (whether U.S.-owned, locally-owned, or owned by companies headquartered in other foreign countries). CFC must set forth its reserves on its Country A annual report and the valuation methodology and valuation assumptions on the Country A X Report, which must be filed annually with the Regulator. The Regulator requires CFC to hold these reserves for the fulfillment of claims owed to policyholders and beneficiaries. The reserves are not catastrophe, deficiency, equalization, or similar reserves. Under the Insurance Rules prescribed by the Regulator for determining reserves required to be calculated and reported for purposes of the Country A annual report, the method, interest rate, the mortality and morbidity assumptions and other factors taken into account provide an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii).

Ruling

Based on the information submitted and the representations made:

1. CFC's underwriting reserves, loss reserves, policyholders' dividend reserves (as defined under section 807(c)(4)), and premiums paid in advance reserves (as defined under section 807(c)(5)), which are required by the Regulator to be maintained for the issuance of life insurance and annuity contracts (other than separate account-type contracts) as reported by CFC on the Country A annual report are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii), and accordingly, the amount of those reserves should be used for purposes of sections 954(i) and 953(b)(3), in determining CFC's Subpart F income.

2. CFC's underwriting reserves, loss reserves, and premiums paid in advance reserves (as defined under section 807(c)(5)), which are required by the Regulator to be maintained for the issuance of life insurance and annuity contracts that are separate account-type contracts as reported by CFC on the Country A annual report are an appropriate means of measuring income within the meaning of section 954(i)(4)(B)(ii), and accordingly, the amount of those reserves should be used for purposes of sections 954(i) and 953(b)(3), in determining CFC's Subpart F income.

This ruling applies to the taxable year ending Day Y.

Caveats

No opinion is expressed on any provisions of the Internal Revenue Code or Treasury regulations not specifically covered by the above ruling. This ruling is subject to revocation if any of the following circumstances occur: (1) a change in the material facts on which this ruling was based; (2) a material change in the business circumstances of CFC which would impact its reserving method; or (3) a change in the applicable law or foreign rules relating to the current reserving method of CFC.

Procedural Statements

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to CFC. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

D. Peter Merkel
Senior Technical Reviewer, Branch 5
Office of Associate Chief Counsel (International)

cc: