

**Internal Revenue Service**

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Person To Contact:

Telephone Number:

Refer Reply To:  
CC:INTL:B05  
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Date:  
September 22, 2011

Legend

Parent =  
U.S. Sub =  
CFC1 =  
CFC2 =  
  
CFC3 =  
  
State A =  
Country =  
A  
Agency =  
Annual =  
Report  
  
X =  
Y =  
Z =

Dear :

We respond to your letter dated X and your supplemental letter dated Z, requesting a ruling that certain reserves held by certain foreign subsidiaries for life insurance and annuity contracts required to be set forth on the financial statements and filed with the life insurance regulators 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 its subsidiaries 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, 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, a State A holding corporation for Parent's life insurance subsidiaries operating in foreign countries. US Sub directly and indirectly owns all the stock of CFC1, CFC2, and CFC3. CFC1, CFC2, and CFC3 were formed under the laws of Country A and are engaged in the life insurance business in Country A. Each is a 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 corporate-center assets and liabilities related to the international insurance business.

Country A regulates any insurance business conducted in Country A through its insurance laws and regulations. A government agency (the "Agency") is responsible for enforcing insurance laws and regulations in Country A. An insurance company must obtain a license from the Agency to conduct an insurance business in Country A.

CFC1, CFC2, CFC3 are licensed by the Agency to sell life insurance and annuity contracts to residents of Country A and are subject to regulation by the Agency as life insurance companies. Each 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). Neither CFC1, CFC2, nor CFC3 carries on non-life insurance businesses other than certain businesses which are incidental to the life insurance business. The life insurance and annuity contracts issued by CFC1, CFC2, and CFC3 are regulated as life insurance and annuity contracts by the Agency. Parent has represented that CFC1, CFC2, and CFC3 would be subject to tax under Subchapter L, if they were domestic corporations.

As required by Country A's insurance laws and regulations: (i) CFC1, CFC2, and CFC3 file annual reports ("Annual Reports") and financial statements with the Agency; (ii) the Annual Reports of CFC1, CFC2, and CFC3 are audited by an outside accounting

auditor in addition to the company's auditor; (iii) the accounting records of CFC1, CFC2, and CFC3 that form the basis for preparing the Annual Reports are subject to inspection by the Agency at any time; and (iv) the Annual Reports of CFC1, CFC2, and CFC3 are made available to the public. CFC1's, CFC2's and CFC3's Annual Reports are used for financial purposes in addition to regulatory purposes, such as for credit rating purposes. Month Y is the official year-end for life insurance companies operating in Country A.

In accordance 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 standards prescribed by the Agency. Any change in the method of calculating such reserves requires advance notice to the Agency and may not be allowed by the Agency.

To comply with Country A's insurance laws, regulations, and other guidance promulgated by the Agency, CFC1, CFC2, CFC3 must establish and maintain certain reserves for obligations to holders of their life insurance and annuity contracts and must set forth the amount of such reserves on the Annual Report. These reserves are (1) underwriting reserves (including reserves for variable contracts) and (2) loss reserves. The rules for calculating these reserves are prescribed by insurance laws, regulations and other Agency guidance and are summarized below.

Underwriting reserves must be held to secure the performance of obligations arising in the future from the life insurance and annuity contracts issued by CFC1, CFC2, and CFC3 in Country A. Underwriting reserves are comprised of insurance premium reserves, unearned premium reserves, and risk reserves. The sum of insurance premium reserves and unearned premium reserves (referred to as the  $\Delta$ standard valuation reserve $\text{\textcircled{A}}$ ) for life insurance and annuity contracts may not be less than the amount calculated in accordance with the designations of the Agency concerning the reserve method, interest rate, mortality rate and other coefficients.

The Agency requires life insurance reserves to be determined as follows: (1) the prescribed reserve method for life insurance is the net level premium ( $\Delta$ NLP $\text{\textcircled{A}}$ ) 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. Under the prescribed rules for variable annuity reserves, the total of amounts credited to the separate accounts for policyholders must be held as premium reserves.

Notwithstanding that 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. The predominate part of the mortality risk reserve is for ordinary death risk, which 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.

Currently, CFC1, CFC2, and CFC3 each holds reserves determined under the NLP method. Each of CFC1 and CFC3 also currently holds some reserves determined under the Zillmer method and special risk reserves comprising both mortality risk reserves and interest rate assumption risk reserves with respect to their Zillmer 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 (including incurred but not reported 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, in accordance with rules and regulations prescribed by the Agency.

In accordance with required rules for life insurance companies licensed to do business in Country A, 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 certain of its subsidiaries have requested a ruling that the underwriting reserves and loss reserves, which are required to be maintained by CFC1, CFC2 and CFC3 by the Agency 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.

### Law

In general, a United States shareholder of a controlled foreign corporation (AFCFC@) 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 Aforeign 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 Aqualified insurance income@ of a Aqualifying insurance company@.

Section 953(e)(3) defines a Aqualifying 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 Aapplicable 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 Aqualified 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) 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)). 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**

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, 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 Code section 954(d)(3)) in Country A. CFC1, CFC2, and CFC3 have 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 with respect to which 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.

CFC1, CFC2, and CFC3 issue life insurance and annuity contracts in connection with the lives and health of residents of Country A, a country other than the U.S. Moreover, CFC1, CFC2, and CFC3 each derive 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). Such contracts are, therefore, exempt contracts within the meaning of section 953(e)(2).

We have 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), for the following reasons:

1. CFC1, CFC2, and CFC3 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 NLP method. However, the Agency allows CFC1, CFC2, and CFC3 to calculate their underwriting reserves under the Zillmer Method provided these companies also maintain special risk reserves for mortality and investment risk. Currently, CFC1, CFC2, and CFC3 each holds reserves under the NLP method. Each of CFC1 and CFC3 also currently holds some reserves determined under the Zillmer method and special risk reserves comprising both mortality risk reserves and interest rate assumption risk reserves with respect to their Zillmer 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 their reserves under the NLP method.
3. CFC1, CFC2, and CFC3 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 generally (whether U.S.-owned, locally owned, or owned by companies headquartered in other foreign countries).
4. The Agency requires that CFC1, CFC2, and CFC3 hold their underwriting reserves to enable them to fulfill claims owed to contractholders and their beneficiaries.
5. Under these circumstances, the underwriting and risk reserves are not catastrophe, deficiency, equalization, or similar reserves.

We have 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), for the following reasons:

1. CFC1, CFC2, and CFC3 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. CFC1, CFC2, and CFC3 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 CFC1, CFC2 and CFC3 to hold loss reserves for the fulfillment of the claims of contractholders and their beneficiaries.

4. CFC1's, CFC2's, and CFC3's loss reserves are not catastrophe, deficiency, equalization, or similar reserves.

### **Rulings**

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

1. Under the facts set forth above, 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.

2. 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.

### **Caveats**

We express no opinion on any provisions of the Code or regulations not specifically covered by the above ruling. In particular, no opinion is expressed regarding whether the IRS would determine if some or all of the risk reserves would constitute foreign statement reserves within the meaning of Code section 954(i)(4)(B)(ii) in circumstances where such risk reserves cause total underwriting reserves to exceed the standard valuation reserve using the reserve method prescribed by the Agency for such contracts. In addition, our rulings are solely determinations 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.

### **Procedural Statements**

This ruling is directed only to Parent and certain of its subsidiaries. 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 representatives.

Sincerely,

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Steven D. Jensen  
Senior Counsel, Branch 5  
(International)