

International Updates

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Agenda

- GILTI and Subpart F High Tax Election
- Foreign Tax Credits
- OECD – Pillars I and II
- BEAT
- Section 954(i)
- Section 807 Reserves
- Passive Foreign Investment Companies

GILTI and Subpart F High Tax Elections (HTE)

- The elective GILTI HTE allows taxpayers to exclude from gross tested income items subject to an effective rate of foreign tax exceeding 18.9%.
 - Election is made annually, and may be applied retroactively.
 - If the election is made, then the GILTI HTE:
 - Applies to all tentative gross income items of a CFC, at the level of each tested
 - unit;
 - Is binding on all US shareholders of the CFC; and
 - Applies to all CFCs that are members of the CFC group.
- The proposed Subpart F HTE would conform to the GILTI HTE, and when the proposed Subpart F HTE is finalized a single unified election would apply to both provisions.
- The steps in assessing whether to make the GILTI HTE include, identifying a CFC group; identifying tested units of each CFC in a CFC group; calculating tentative tested income, and calculating effective foreign tax rate on each tentative tested income item.

Tentative Tested Income

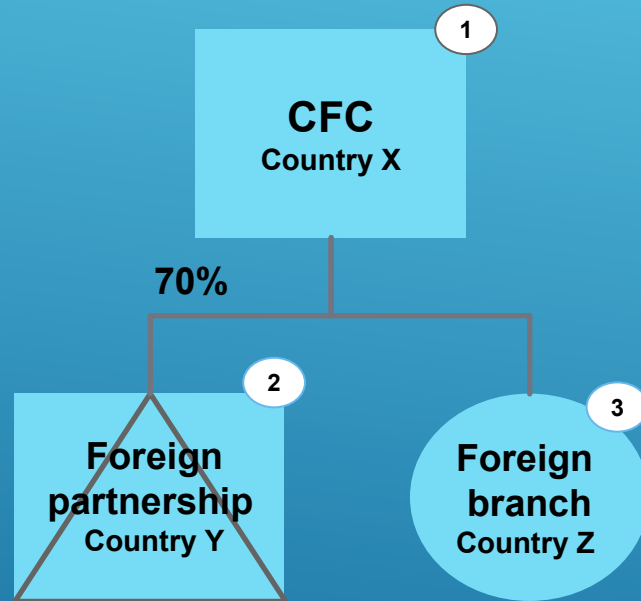
- A tentative gross tested income item of a CFC is the aggregate of all items of gross income of the CFC attributable to a tested unit of the CFC in the CFC inclusion year that would be gross tested income in a single tested income group.
 - Items of gross income of a CFC are attributable to the CFC's tested unit to the extent they are properly reflected on the separate set of books and records of the tested unit.
- Tentative tested income:
 - Allocate/apportion deductions (including current year taxes) for the CFC inclusion year to the CFC's tentative gross tested income items
 - "Under the principles of Reg. Section 1.960-1(d)(3)," treating each tentative gross income item as assigned to a separate "tested income group"
 - Special rule: For purposes of applying Reg. Sections 1.861-9 and 1.861-9T, the amount of interest deductions that are allocated and apportioned to the assets (or gross income) of a lower-tier corporation are allocated and apportioned to the residual income category.
- Special rule for certain current year taxes:
 - Taxes "reasonably certain" to be returned to a shareholder on a subsequent distribution to the shareholder;
 - Directly or indirectly, through any means (refund, credit, payment, discharge of an obligation, or any other method).
- Current year taxes imposed by reason of disregarded payments are allocated and apportioned under the principles of Reg. Section 1.904-6(a)(2)

Subpart F HTE Proposed Regulations

- The 2020 Proposed Regulations would create a single unified HTE for the Subpart and GILTI.
 - The unified HTE election applies for both Subpart F and for GILTI.
 - The GILTI HTE incorporates the Subpart F HTE by reference to Reg. Section 1.954-1(d).
 - Nearly all of the text of GILTI HTE under the Final Regulations in Reg. Section 1.951A-2(c) is proposed to be removed and the unified HTE is proposed under Reg. Section 1.954-1(d).
- Section 952(c) interaction with the high tax elections
 - GILTI – where an effective rate of foreign tax with respect to a tentative net item results in an undefined or negative effective foreign tax rate, resulting in a tentative net item being deemed to be high-taxed (e.g., in the case of a net loss), such loss may be unavailable to offset other tested income of the US shareholder in computing its GILTI inclusion amount.
 - Subpart F - the disallowance of a tentative net loss in Subpart F may create a mismatch of income and expenses resulting from the same insurance contract, where the utilization of losses may be lost permanently for purposes of determining the Subpart F income amount.

Identifying the tested units of a CFC

Reg. Section 1.951A-2(c)(7)(iv)

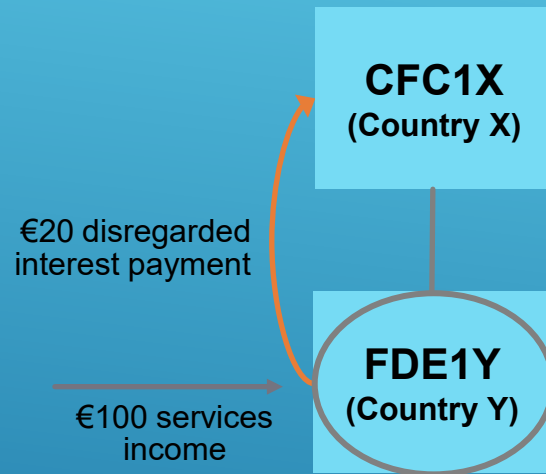


A tested unit is:

- The CFC itself
- An interest in a pass-through entity (e.g., a partnership or disregarded entity) that is held directly or indirectly by the CFC and that is either:
 - A tax resident of any foreign country, or
 - **Not treated** as fiscally transparent for purposes of the tax laws of the country in which the CFC is tax resident (or, if the interest is held by the CFC indirectly through one or more other tested units, for purposes of the tax law of the foreign country of which the tested unit that directly (or indirectly through the fewest number of transparent interests) owns the interest); or
- A branch, the activities of which are carried on directly or indirectly (through one or more pass-through entities) by the CFC
 - A branch that does not give rise to a taxable presence in the country in which it is located is treated as a branch only if income attributable to the branch is exempt or taxed preferentially under the tax laws of the CFC or tested unit carrying on the branch's activities

GILTI High-Tax Exclusion: Disregarded Payments

Reg. Section 1.951A-2(c)(8)(iii)(E) (Example 1)



- Disregarded payments between tested units will generally require a reallocation of gross income to appropriately associate the gross income with the tested unit where the income is subject to tax.
- Adjustments generally follow the principles of the foreign branch basket rules that apply for foreign tax credit purposes (Reg. Section 1.904-4(f)(2)(vi)), subject to certain modifications.
- In particular, disregarded payments of interest may reallocate gross income.
- Special ordering rules apply when a tested unit makes **and** receives disregarded payments.

	Local books	US-adjusted books	Reallocation	Tentative gross tested income item
CFC1X gross income item	€20	€0	€20	€20
FDE1Y gross income item	€100	€100	<€20>	€80

Foreign Tax Credits

- On December 2, 2019, Treasury released final and proposed foreign tax credit regulations.
- The 2019 proposed regulations generally covered additional guidance around the allocation and apportionment of expenses and the association of foreign taxes to income.
- The more notable provisions included Prop. Reg. Section 1.861-20 and the rules defining financial services group, financial services entity, and financial services income.
- Following the 2019 regulation package, Treasury issued additional proposed and final regulations on September 29, 2020 (TD 9922). This package finalized some of the 2019 proposed regulations and included additional proposed regulations.
- The 2020 proposed regulations:
 - Require that section 818(f) expenses be allocated and apportioned on a life subgroup basis, but a one-time election is allowed for consolidated groups to choose instead to apply a separate company approach. A consolidated group's use of the separate entity method constitutes a binding choice to use the method chosen for that year for all members of the group and all taxable years thereafter.
 - Retain the general approach of the existing §1.904-4(e) final regulations by providing a numerical test whereby an entity is a financial services entity if more than a threshold percentage of its gross income is derived directly from active financing income. However, the proposed regulations lower the threshold from 80 percent to 70 percent, and further provide that active financing income must generally be earned from customers or other counterparties that are not related parties.

Foreign Tax Credits

- Impose a cap on the amount of an insurance company's income from investments that may be treated as active financing income. The cap is determined based on an applicable percentage of the insurance company's total insurance liabilities and adopts different percentages for life v. P&C insurance company liabilities.
- Change the definition of financial services income and change the "laundry list" of active financing income items.
- Contain a new comprehensive set of rules addressing the allocation and apportionment of income taxes relating to disregarded payments:
 - Generally assign recipient's foreign gross income arising from the receipt of disregarded payments and the associated foreign taxes based on the current or accumulated income of the payor.
 - Leverages the income reattribution rules used in the foreign branch and GILTI high tax exclusion provisions.
 - Gross income and foreign taxes are allocated at the "taxable unit" level.
 - For individuals or domestic corporations, "taxable unit" means a foreign branch, foreign branch owner, or certain non-branch taxable units.
 - For foreign corporations, "taxable unit" means a tested unit.

Foreign Tax Credits

- Notable provisions in the 2020 proposed regulations would:
 - Fundamentally overhaul the creditability requirements of a foreign income tax under IRC Sections 901 and 903 by requiring jurisdictional nexus for the tax to be creditable (without considering the location of customers or users as a significant factor).
 - Introduce new rules under Treas. Reg. Section 1.861-20 for allocating and apportioning foreign income taxes imposed on (i) dispositions of stock and partnership interests, and (ii) disregarded payments made between "taxable units" that generally would categorize foreign taxes based on the income of the payor making the disregarded payment.
 - Disallow foreign tax credits and deny deductions under IRC Section 245A(d) for foreign income taxes attributable to any dividend for which a deduction under IRC Section 245A would be allowed.
 - Add an election to capitalize and amortize R&E and advertising expenditures for purposes of apportioning interest expense under Treas. Reg. Section 1.861-9.
 - Treat, for purposes of computing the IRC Section 250 FDII deduction, services as electronically supplied services if the value of the service to the end user is derived primarily from the service's automation or electronic delivery, as opposed to human effort (e.g., legal, accounting, medical, or teaching services).

Foreign Tax Credits

- The 2020 final regulations that finalized prior 2019 proposed regulations regarding the treatment of income and assets generating dividends-received deductions and tax-exempt interest held by insurance companies for purposes of allocating and apportioning deductions to such income and assets.
 - Very generally, under section 864(e)(3), in apportioning various deductions, exempt income and exempt assets are not taken into account. The final regulations provide that that in the case of insurance companies, exempt income includes dividends for which a deduction is provided by sections 243(a)(1) and (2) and 245, without regard to the proration rules under section 805(a)(4)(A)(ii) disallowing a portion of the deduction attributable to the policyholder's share of the dividends or any similar disallowance under section 805(a)(4)(D).
 - Similarly, the final regulations provided that the term exempt income includes tax-exempt interest without regard to the proration rules. Taxpayer comments noted that section 864(e)(7) provided authority to issue regulations for appropriate adjustments in the case of an insurance company.
 - Although the US Treasury declined to adopt rules to provide for any such adjustment, the preambles' response to the taxpayer comments failed to address the purpose of section 864(e)(7) and how final regulations could be issued without addressing how section 864(e)(7) should be applied.

Foreign Tax Credits

- The 2020 final regulations also include provisions that would:
 - Allocate and apportion foreign income taxes to gross income under Treas. Reg. Section 1.861-20, including for purposes of categorizing taxes to separate IRC Section 904(d) categories, by:
 - Allocating taxes on foreign income items with no corresponding US income item.
 - Identifying an exclusive list of "base differences" (for which a foreign tax credit under IRC Section 960 is effectively denied) that no longer includes foreign law distributions treated as a return of basis for US federal income tax purposes.
 - Describing the treatment of (regarded) distributions.
 - Retain mandatory sales-based apportionment of R&E expense to all gross intangible income related to the relevant product SIC code, specifically excluding GILTI, subpart F inclusions and dividends.
 - Provide that exclusive apportionment of R&E expense does not apply for purposes of computing foreign-derived intangible income (FDII).
 - Clarify that stewardship expenses are allocated to domestic and foreign dividends, GILTI, and subpart F inclusions, and apportioned based on the value of the domestic and foreign stock.
 - Add an election under IRC Section 905(c) to account for certain foreign tax redeterminations of a CFC for pre-2018 tax years as if they occurred in the CFC's last tax year beginning before January 1, 2018.
 - Reduce hybrid deduction accounts under IRC Section 245A(e) by reason of certain subpart F income and GILTI, and provide guidance on the treatment of certain stock as a financing transaction under the conduit financing rules of Treas. Reg. Section 1.881-3.

Example – Disregarded Reattribution Payment

- ▶ \$100x passive foreign personal holding company income (FPHCI)
- ▶ \$300x gross tested income
- ▶ If regarded, the \$1000x payment would be allocated ratably to FPHCI and tested income
- ▶ No Country A taxes

- ▶ \$1000x foreign gross income
- ▶ \$100x Country B taxes



Reattribution

- Payor taxes are allocated **without** regard to reattribution of gross income
- Payee taxes are allocated **after** \$400x of gross income is reattributed to Payee (\$100x of FPHCI, \$300x of tested income)
- Excess of disregarded payment over reattributed income (\$600x) is treated as a contribution from Payor to Payee

Allocation of foreign taxes

- Payee
 - \$10x – passive FPHCI
 - \$30x – tested income
 - \$60x – residual (no credits)

OECD – BEPS Pillars I and II

- **Overall process and timing**

- The OECD released Pillar 1 and Pillar 2 “blueprints” on October 12. Deadline for comment is December 14. Public consultation is scheduled for January 2021 with OECD work concluding by mid-2021

- **Pillar One – Transfer pricing and partial formulary approach**

- Objective:
 - Replacing unilateral action on digital services taxes with a global approach to allocating profits to market jurisdictions, in part by adopting a formula to the ALP -- a huge political and policy change -- along with dispute prevention and dispute resolution mechanisms that some countries are hesitant to adopt.
- The October report set out progress made between January and October and illustrate areas where issues are still open and merit further consultation/discussions. Preliminary drafts provide strong case for exclusion for financial services from “Amount A.”

- **Pillar Two – Model minimum tax and backstops to assure MNEs pay a minimum level of tax**

- Objective:
 - MNEs should pay their fair share, at a time when countries are hurting for tax revenues, by having all MNEs pay a minimum level of tax on profits.
- Technical and political details much further along and political agreement seems much more reachable, though some countries want to link Pillars 1 and 2.

OECD – Pillar II: Basic Architecture of GloBE

Based on an agreed worldwide **minimum tax rate** at which income needs to be taxed

Income Inclusion rule (IIR) (min tax rule)

- Where income of a multinational enterprise (MNE) (earned through a subsidiary or branch) is not subject to the agreed minimum level of tax, the MNE would be subject to a “top-up” tax in the parent jurisdiction.
- Scope and impact of GILTI grandfather rules
- Allocation of income and taxes between jurisdictions
- Impact on inbound payments

Undertaxed Payment rule (UTPR) (backstop rule)

- The UTPR is a backstop to the IIR which allocates a top-up tax to a UTPR taxpayer from a low-taxed Constituent Entity. The top-up tax is allocated based first on deductible payments from the UTPR taxpayer and second in proportion to the total amount of net intra-group expenditure incurred by all UTPR Taxpayers.
- The UTPR top-up tax can be effected either by denying a deduction for an intercompany payment or making an equivalent adjustment under domestic law.

Switch-over rule

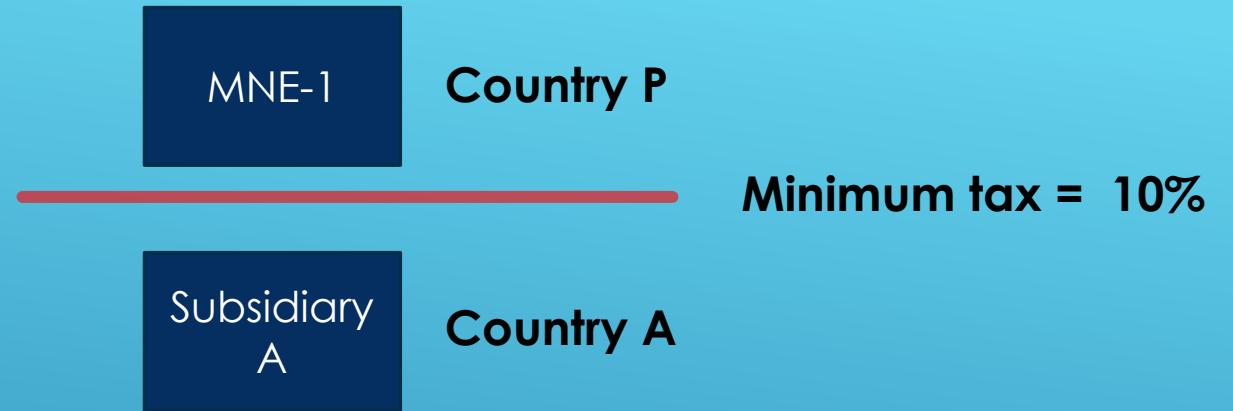
- Blending of tax rates on foreign branches' income is prevented by allocating income and tax between the parent and the PE jurisdiction. The switch-over rule allows the parent jurisdiction to tax income of the PE under the IIR where the treaty would otherwise prohibit it.

Subject to tax rule (STTR)

- Where payments made to connected persons are subject to reduced withholding under treaties, withholding may be increased by payor country if payments not taxed above agreed minimum level.
- Applies without regard to min tax paid under IIR. Tax imposed pursuant to the STTR is a covered tax.

OECD – BEPS Pillar II

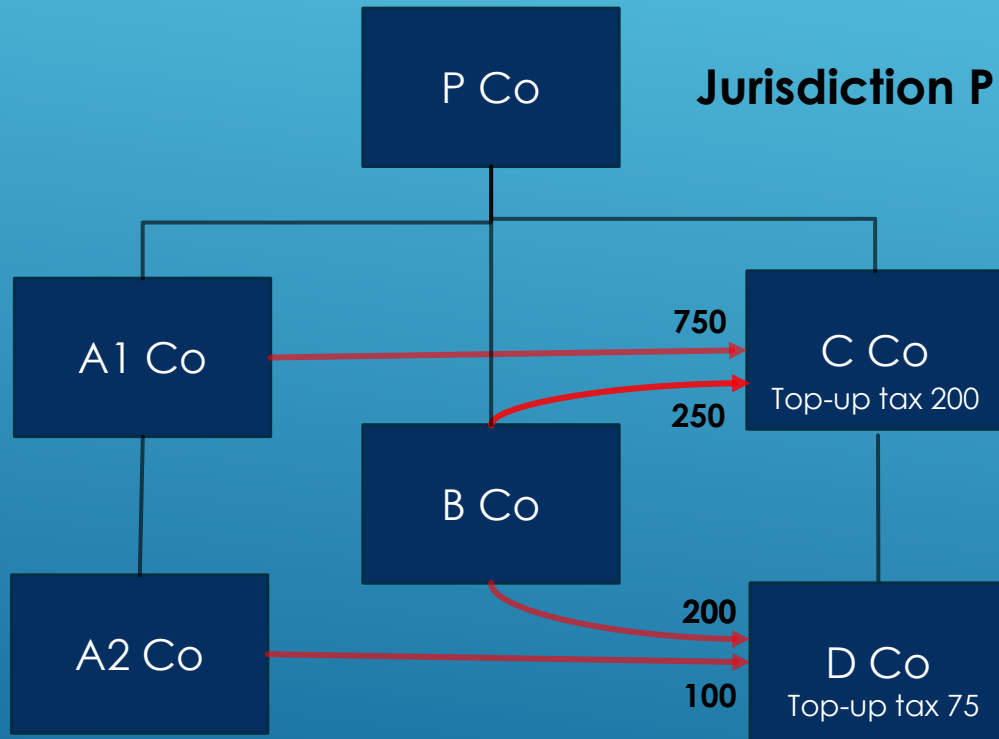
This example pulled from the Pillar II blueprint (Example 4.2.1A) illustrates the operation of the IIR as well as the operation of the local tax carryforward rule.



Subsidiary A	Year 1	Year 2	Year 3
Income	1,000	1,000	1,000
Minimum tax (10%)	100	100	100
Local tax paid (Jurisdiction A)	140	80	50
Effective tax rate	14%	8%	5%
Excess taxes	40	0	0
Local tax carry forward used	0	20	20
Local tax carryforward remaining	40	20	0
GloBE Tax (top up to 10%)	0	0	10

OECD – BEPS Pillar II

This example pulled from the Pillar II blueprint (Example 7.4.3A) illustrates the operation of the first allocation key of the UTPR.



- The top-up tax allocated to A1 Co equals 150 $(200 \times (750/1000))$
- The top-up tax allocated to A2 Co equals 25 $(75 \times (100/300))$
- The top-up tax allocated to B Co equals 100 $(200 \times (250/1000) + 75 \times (200/300))$

BEAT – Inward Reinsurance

- Final Regulations provide an exception from base erosion payments for amounts paid by a taxpayer subject to tax under subchapter L to a foreign related party that is a regulated insurance company under a reinsurance contract for losses incurred (as defined in Section 832(b)(5)) and claims and benefits under Section 805(a)(1). (Does not apply to other amounts such as ceding commissions). The excepted amounts are excluded from the numerator and denominator for computation of the base erosion percentage.
- The amounts paid or accrued must be properly allocable to amounts required to be paid by the foreign related party, pursuant to an insurance, annuity, or reinsurance contract, to a person other than a related party. For purposes of this exception, the determination of whether a contract is an insurance contract or an annuity contract is made without regard to Sections 72(s), 101(f), 817(h), and 7702, provided that the contract is regulated as a life insurance or annuity contract in its jurisdiction of issuance, and no policyholder, insured, annuitant, or beneficiary with respect to the contract is a US person.
- Further, the term ‘regulated foreign insurance company’ means any foreign corporation that (1) is subject to regulation as an insurance (or reinsurance) company by the country in which the corporation is created, is organized, or maintains its registered office, and is licensed, authorized, or regulated by the applicable insurance regulatory body for that country to sell insurance, annuity, or reinsurance contracts to persons other than related parties in that country, and (2) would be subject to tax under subchapter L if it were a domestic corporation.

BEAT – Reinsurance Premiums and Netting

- The Preamble to the Final Regulations notes that amounts of income and deduction generally are determined on a gross basis under the Code, and, unless a rule permits netting (so that there is no deduction, or the deduction is a reduced amount, as opposed to a deduction offset by an item of income), no netting is permitted under the Final Regulations.
- The Preamble observes that subchapter L provisions cited in Section 59A(d)(3) (Section 803(a)(1)(B) for life insurance companies and Section 832(b)(4)(A) for non-life insurance companies) do not provide for netting of ceding commissions, claims payments, or other expenses against premiums.
- With respect to a comment that modified coinsurance and other reinsurance contracts that are periodically settled on a net basis are substantially similar to derivative contracts, Treasury and the IRS note that Section 59A(h)(4)(C) provides that the term ‘derivative’ does not include insurance contracts, indicating that Congress did not intend for agreements with derivative-like characteristics that also are insurance contracts to be treated as derivatives for purposes of Section 59A.

BEAT – Consolidated Returns

- Similar to the 2018 Proposed Regulations, the Final Regulations clarify that the BEAT is computed and imposed at the consolidated group level. This is consistent with the general approach of computing and imposing the regular tax liability of the members of an affiliated group that file a consolidated return on a single-entity basis.
- Also consistent with single-entity treatment, items from intercompany transactions are not taken into account for purposes of computing the BEMTA.
- For example, intercompany reinsurance and service payments between members of a consolidated group are ignored for this computation. To make clear that intercompany transactions may not impact the BEAT consequences of a consolidated group, the Final Regulations clarify in Treas. Reg. Sec. 1.1502-59A(b)(1) that items resulting from intercompany transactions are not taken into account in computing the group's base erosion percentage and BEMTA.
- The Preamble notes that some comments raised concerns that the 2018 Proposed Regulations and Prop. Reg. Sec. 1.1502-59A may be incompatible with the rules and framework of Treas. Reg. Sec. 1.1502-47 for life-nonlife consolidated groups. Treasury and the IRS state that they are analyzing these concerns and expect to address the issues in future proposed regulations, and thus reserve on this matter in the Final Regulations.

BEAT – Waiver of Deductions

- Section 59A(d)(1) defines ‘base erosion payment’ as any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is ‘allowable.’ Section 59A(c)(2)(A) defines ‘base erosion tax benefit’ in reference to deductions ‘allowed’ for the taxable year.
- The 2019 Proposed Regulations provide that all deductions that could be claimed by a taxpayer for the tax year are treated as allowed deductions for purposes of determining a taxpayer’s base erosion tax benefits, and thus, the taxpayer’s base erosion percentage.
 - However, the 2019 Proposed Regulations provide that taxpayers may elect, on an annual basis, to waive certain deductions (on an original return, an amended return, or during exam) and thus not take those deductions into account as base erosion tax benefits.
- The 2020 Final Regulations adopted this waiver with the same procedures as those laid out in the 2019 Proposed Regulations, stating that all deductions that could be claimed by a taxpayer as “allowed deductions” for purposes of determining base erosion tax benefits and base erosion percentage may be waived.
 - These regulations clarified that an amended return may not decrease or revoke a prior waved deduction and included new provisions addressing the waiver for partnerships.
 - Notably, the BEAT waiver election was extended to the waiver of any premium or other consideration paid or accrued by an insurance company for any reinsurance payments that would be a base erosion tax benefit.
 - Premiums that are reductions to gross income do not technically fit within the terminology used in the waiver provisions.
 - In general, the BEAT wavier election only applies by its terms to “deductions.”
 - However, a base erosion tax benefit generally also includes reductions in gross income for any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payment.

Section 954(i) – Overview

- For taxable years beginning after December 31, 1998, §954(i) provides that foreign personal holding company income does not include qualified insurance income of a qualifying insurance company (QIC).
- Qualified insurance income means income of a QIC equal to the sum of two amounts: the unrelated ordinary and necessary investment income attributable to exempt contracts and the unrelated investment income attributable to exempt contracts from required surplus. Section 954(i)(2).
- This results in investment income generated by exempt contracts being eligible for deferral.
 - Income must be received from an unrelated person.
- The amount eligible for deferral is a function of the amount of the assets supporting the related reserves. The reserves are calculated according to specific tax rules.
- Investment income in excess of Section 954(i) formula is taxed as foreign personal holding company income under Section 954(c).
- For life and annuity business, deferral is on investment income from assets supporting 110% of reserves.
- For all other business, deferral is on investment income from:
 - Assets supporting loss reserves,
 - Assets supporting 80% of UPR, and
 - Assets from one-third on premium earned.
- Section 954(i) and the reserve computation is also used in computing taxable income for GILTI purposes.

Life Insurance Reserves under Section 954(i)(4)(B)

- Before TCJA, foreign companies would apply the US methodology under Section 954(i)(5) for computational reserves, which included prescribed interest rates and mortality/morbidity tables. For taxpayers who preferred another approach, they could obtain a ruling to use foreign statement reserves.
 - Reserves had to be determined on the date the contract was issued and reserves booked.
- After TCJA, reserves must be computed based on the methods in Section 807(d)(3) as if the foreign insurance company were a domestic company. This is a NAIC prescribed method, but neither interest rates, mortality or morbidity tables, or other assumptions are prescribed, leaving such determinations to the actuaries, under standards provided by insurance regulators.
 - Consistent with the changes made by TCJA, foreign reserves in foreign financial statements would appear to generally meet the purposes of Section 807(d)(3) and Section 954(i)(5).
 - This position should not affect any existing Section 954(i)(4)(B)(ii) rulings.
- Treasury does have a Section 954(i) guidance project and there is interest in providing a common standard.
- Neither the statute nor legislative history appears to require the 807(d)(1)-like haircut to Section 954(i)(4)(B) reserves.
 - Section 954(i)(5) calculates the amount of the reserve and corresponds to Section 807(d)(2), not Section 807(d)(1), and neither Section 954(i)(4) nor Section 954(i)(5) refer to a haircut on reserves.

Property and Casualty Reserves under Section 954(i)(4)(A)

- 954(i)(4)(A) – imposes an interest rate for property and casualty companies to determine reserves.
 - The interest rate is calculated in the same manner as the federal midterm rate in Section 1274(d).
 - The Section 846 discount rate that previously applies has been modified to the corporate yield bond rate resulting in a lower discount.
 - Notice 2002-69 can continue to apply in determining foreign loss payment patterns.
- Following these changes, the application of Section 954(i)(4)(A) remains unclear.
 - The question is whether to use the bond method or the AFR under the old method.
 - It would appear that the foreign loss payment pattern is still applicable as enumerated in Notice 2002-69.

Section 807 – Life Insurance Reserves

- Preamble language to proposed regulations issued on April 2, 2020 providing guidance on the computation of life insurance reserves requested comments on whether some reserves coming into the US (reinsurance) should be treated as life insurance reserves without regard to sections 7702 and 72(s). While sections 814(f) and 101 play a role in this context, Section 814(f) is less significant than foreign-issued, equity-linked life or annuity contracts, which are generally not reinsured into the United States. Additionally, Section 101 is a predecessor to Section 7702.
- If this rule is adopted, the result is that Section 807(c)(1) reserves are available for US life insurance companies for foreign-issued life insurance contracts when computing taxable income and in determining their status as a life insurance company without regard as to whether the underlying foreign-issued insurance contracts meet sections 7702 or 72(s). Presumably, this rule should particularly not apply if the owner, policyholder, or annuitant is not a US Person. Also, this rule would not apply if the policy is effectively connected (or attributable to) a US trade or business (or US permanent establishment) of the foreign insurance company issuing such policy.
 - This provision would eliminate any uncertainty as to the characterization of the reserves of such contracts and as to the status of the company as a life insurance company.
 - Additionally, DAC would then apply, providing certainty and a proper policy approach but not necessarily producing a better tax result in all cases.
- A similar comment has been made in the PFIC context for foreign life and annuity insurance contracts. Additionally, similar changes were made in the BEAT for the definition of claims payments and in subpart F under 953(e)(5). For Section 953(e)(5) purposes, the ultimate owner, policyholder, or annuitant cannot be a US-person.

Section 807 – Life Insurance Reserves

- These approaches remain consistent with domestic and US international policy considerations due to the requirement that the beneficiary of the contract or annuitant is a non-US person and the requirement that the contract is regulated as a life insurance contract by a foreign regulator. These approaches also are consistent with the aim of TCJA of incentivizing non-US business to relocate to the US.
- Further, characterizing the reserve as a life insurance reserve in this reinsurance context:
 - does not affect the character, source and separate category basket in which income derived from the reinsurance is included for US withholding tax or foreign tax credit purposes;
 - does not alter the application of any applicable US withholding tax on income from sources within the United States paid by the domestic insurance company to any foreign corporation, including under sections 871(a), 871(m), 881, 1441 and 1442;
 - does not affect the treatment under Section 59A (BEAT) of any claims and benefits or any other amounts paid by a domestic insurance company to a foreign related party under a reinsurance contract; and
 - should not apply to any Foreign Life Insurance and Annuity Contracts issued by a foreign corporation when premiums received from such contracts are treated as effectively connected with the conduct of a trade or business in the United States, or attributable to a permanent establishment within the United States under an applicable tax treaty, of such foreign corporation.
- Final regulations published in October 2020 effectively deferred the application of these regulations. *See Computation and Reporting of Reserves for Life Insurance Companies*, 85 Fed. Reg. 64386 (October 13, 2020).

Passive Foreign Investment Companies

- **PFIC Defined** – A PFIC is defined as any foreign corporation if, for the taxable year,
 - 75 percent or more of its gross income is passive income (the "**PFIC Income Test**"), or
 - at least 50 percent of its assets are held for the production of passive income (the "**PFIC Asset Test**").
- **Insurance Company Exception to PFIC Status** –The exception to the PFIC rules for insurance companies under Section 1297(b)(2)(B), as modified by the 2017 Tax Cuts and Jobs Act (“TCJA”), requires:
 - (1) that an insurance company be characterized as a qualifying insurance corporation (“**QIC**”). Generally, Section 1297(f) provides that a QIC is a foreign corporation that (a) would be subject to tax under subchapter L if it were a domestic corporation and (b) has applicable insurance liabilities that constitute more than 25% of its total assets.
 - (2) that its income be derived in the **active conduct of an insurance business**.
- **Alternative facts-and-circumstances test** – If a corporation fails to qualify as a QIC solely because applicable insurance liabilities are 25 percent or less of total assets, a U.S. person that owns stock in such corporation may elect to treat such stock as stock of a QIC, if:
 - The percentage so determined for the corporation is at least 10 percent , and
 - Under regulations provided by the Secretary, based on the applicable facts and circumstances, (i) the corporation is predominantly engaged in an insurance business, and (ii) such failure is due solely to runoff-related or rating-related circumstances involving such insurance business.
- **Look-through Rules** – Various “look-through” rules apply to a tested foreign corporation’s subsidiaries and related parties for purposes of the PFIC Tests.

2019 PFIC Proposed Regulations – Highlights

- In July 2019, Treasury and the IRS released **prospectively-applicable** proposed regulations under Sections 1291, 1297, and 1298, providing guidance with respect to, *inter alia*, the income test, the asset test, the PFIC look-through rules, and various PFIC exceptions, including, notably, the insurance company exception.
- **Definition of Active Conduct**
 - Prop. Reg. § 1.1297-5(c)(3)(i) provides that the term “active conduct” is based on all of the facts and circumstances and that, in general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out **substantial managerial and operational activities**. For this purpose, active conduct is intended to be interpreted consistently with the active conduct standard in § 1.367(a)-2(d)(5).
 - The proposed regulations further provides that a QIC’s officers and employees are considered to include the officers and employees of another related corporation if the QIC satisfies the control test set forth in Prop. Reg. § 1.1297-5(c)(3)(ii).
 - Under Prop. Reg. § 1.1297-5(c)(4), a QIC determines the annual amount of its income that is derived in the active conduct of an insurance business by determining its “**active conduct percentage**” for purposes of an **all-or-nothing income determination**.
 - The numerator is the expenses for services of officers and employees of the QIC related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance contracts issued by the QIC.
 - The denominator is the sum of the numerator and expenses paid by the QIC to a person other than a person whose services for the QIC are covered by the expenses included in the numerator.
 - If the QIC’s active conduct percentage is greater than or equal to 50%, then **all** of the QIC’s income is excluded from passive income pursuant to the exception in Section 1297(b)(2)(B) for the active conduct of an insurance business. Otherwise, **none** of its income is excluded from passive income.
 - Consider how the above changes may have shaped the ‘active conduct’ test into a requirement that is separate to the ‘insurance liabilities’ test.
 - Consider how the above changes reflect an overarching shift away from the ‘facts and circumstances’ test and towards an objective standard expected to ensure greater administrability and tax certainty.

2019 PFIC Proposed Regulations – Highlights

- **Qualifying domestic insurance corporation (“QDIC”) exception**
 - A qualifying domestic insurance corporation is defined as a domestic corporation that is subject to tax as an insurance company under subchapter L and is subject to federal income tax on its net income.
 - The Proposed Regulations provide that income and assets of a QDIC are considered non-passive for purposes of applying the PFIC Tests.
 - *Exceptions - when applying attribution rules for indirect shareholders of PFICs*
 - The QDIC rule only comes into play if a TFC applies Section 1297(c) to look-through a QDIC. The Proposed Regulations, however, provide that the QDIC rule does not apply to determine whether a TFC is a PFIC for purposes of Section 1298(a)(2) and Prop. Treas. Reg. Sec. 1.1291-1(b)(8)(ii) (the ‘QDIC rule exception’).
 - For example, a foreign holding company that owns a foreign insurance company that is not a QIC and is a PFIC, and also owns a domestic insurance company that is a QDIC, may be determined to be not a PFIC by applying Section 1297(c). However, a US person with a minority interest in the foreign holding company may be deemed to own an indirect interest in the foreign insurance company that is a PFIC under Section 1297(a)(2)(A) by applying this rule.
 - But for the QDIC rule exception, the ownership of the PFIC would not be attributed to the US person under Section 1298(a)(2)(B) as it owns less than 50% of the foreign holding company which is not a PFIC.

2019 PFIC Proposed Regulations – Highlights

• PFIC Domestic Look-Through Rule and the Proposed Regulations

- The Domestic Look-Through Rule (DLTR) in Section 1298(b)(7) provides that a foreign corporation that is subject to the accumulated earnings tax (AET) under Section 531 and owns at least 25% of a domestic corporation, then any stock held by such domestic corporation in a domestic C corporation that is not a RIC or REIT is treated as non-passive for the asset test and any gross income on such stock is non-passive for the income test.
- Two rules in the proposed regulations operate as anti-abuse rules to the DLTR.
 - The first rule is a hypothetical PFIC test that requires a foreign corporation, as a precondition for qualifying for the DLTR, to show that it would not be a PFIC under an alternative income and asset test that excludes stock of domestic corporations qualifying for the DLTR and income from such.
 - The second rule denies the application of the DLTR where a 25% owned domestic subsidiary is not engaged in an active trade or business in the US, or if such subsidiary is engaged in an active trade or business, the principal purpose for forming the subsidiary is to avoid PFIC status
- DLTR and the Attribution Rules under Section 1298(a)(1)-(2)
 - The proposed attribution rules would operate to exclude the DLTR for purposes of Section 1298(a)(2).
 - If a foreign corporation is not a PFIC because of the application of the DLTR, it will be treated as a PFIC for Section 1298(a)(2) attribution purposes, potentially causing the TFC's minority US shareholders to be treated as owning their proportionate share in the stock of any lower-tier PFIC of the foreign corporation, regardless of their ownership level in the foreign corporation.
 - Consider the application where the insurance exception or DLTR are relied upon at the top-tier level; these regulations effectively turn these rules off forcing look-through all the way through the chain of ownership.

2019 PFIC Proposed Regulations – Highlights

- **PFIC Insurance Exception and Section 954(i)**

- The statutory PFIC insurance exception rule was aimed at identifying certain insurance companies that were perceived as acting more like an investment company than an insurance company. If the requirements of the statute are met (25% assets threshold), then all activities are seen as active.
- In the Section 954(i) context, the only assets treated as active are those assets equal to an amount of reserves and certain capital related to insurance policies issued to unrelated persons in the “home country” of such foreign insurance company. Thus, only a limited amount of assets directly allocable to home country activities are treated as active.
 - The nature of the activities treated as active are thus limited to those insuring foreign country risk or those insuring “home country” risk where the insureds are unrelated and there is substantial activity in the home country. The effect is that only investment activities in proportion to the amount of insurance activities can qualify as active.
- The proposed regulations turn off Section 954(i) in the PFIC rules does not appear warranted as the PFIC exception is aimed at an investment like structure, and Section 954(i) is specifically tailored to address a limited amount of assets tied to certain reserves and capital.
 - Thus, Section 954(i) appears to only apply where you presumably do not meet the Section 1297(f) rule. The treatment as active under Section 954(i) only covers assets treated as Section 954(i) reserves and certain amounts of capital, resulting in a targeted rule that prevents the abuse discussed above.