November 15th, 2021

Internal Revenue Service
ATTN: Kinna Brewington
Room 6529
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Sir or Madam:

On September 14th, 2021, the Internal Revenue Service ("**IRS**") published a request in the Federal Register[1] soliciting comments from taxpayers related to interest rates and foreign loss payment patterns for a foreign company conducting a nonlife insurance business used to determine Qualified Insurance Income under section 954(i) of the Internal Revenue Code.[2] Comments were requested by November 15th, 2021. American International Group, Inc., Chubb, Factory Mutual Insurance Company, and Tokio Marine HCC, each of which is either the common parent, or a member, of a consolidated group that includes an insurance company taxed under subchapter L with extensive operations in the United States and globally, each of which appreciate the opportunity to collectively submit comments on this topic. Additionally, each consolidated group listed above also has several controlled foreign corporations ("**CFCs**"), as defined under section 957, that would be taxed under subchapter L if they were domestic companies and thus are subject to the provisions of sections 953 and 954, including the requirement to calculate unpaid loss reserves under sections 953(b)(3) and 954(i) for certain US federal tax purposes.

Our comments primarily address the complexities and uncertainties of calculating reserves under section 954(i) faced by nonlife insurance businesses in CFCs. We note that the Priority Guidance Plan[3] published by the Department of the Treasury ("**Treasury"**) and the IRS for this topic has been in place since before the enactment of the Tax Cuts and Jobs Act of 2017 ("**TCJA**"),[4] and we appreciate the opportunity to help address this outstanding item. Additionally, proposed foreign tax credit regulations published in November 2020[5] reference section 953(b)(3) reserves, which, in turn, references reserves described under section 954(i). The need for guidance in the near

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[1] *See Proposed Extension of Information Collection Request Submitted for Public Comment; Comment Request on Burden Related to Interest Rates and Appropriate Foreign Loss Payment Patterns for Certain Controlled Corporations*, 86 Fed. Reg. 51225 (September 14th, 2021).

[2] Unless otherwise noted, all Code and "section" references are to the Internal Revenue Code of 1986, as amended (the Code), and all "Treas. Reg. §" or "Prop. Reg. §" references are to the Treasury regulations promulgated thereunder.

[3] *See* 2016-2017 Priority Guidance Plan, Department of the Treasury at International, A. Subpart F/Deferral, 2. Guidance under §954, including regarding foreign base company sales and services income, and the use of foreign statement reserves for purposes of measuring qualified insurance income under §954(i) (August 15, 2016).

[4] P.L. 115-97.

[5] *Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income*, 85 FR 72078 (November 12, 2020).

future is necessary as CFCs with nonlife insurance business have Subpart F income and/or global intangible low-taxed income ("**GILTI**") and need a reliable method to determine the appropriate category, and amount, of income under US federal tax law. Whether a company's income is Subpart F or GILTI can have major implications on a company's foreign tax credit calculation, certain high-tax provisions, and effective tax rate numbers, which are material items for many (if not all) companies in the industry.[6]

This letter sets forth a summary of the history, purpose, and current application of sections 846 and 954(i)(4)(A), as well as of Notice 2002-69, and proposes a solution in the form of two safe harbor approaches that rely on: (i) the use of foreign jurisdiction statutory reserves and/or (ii) the use of generally accepted accounting principles ("**GAAP**"), international financial reporting standards ("**IFRS**") or local statutory reserves for unpaid losses, to which are applied domestic discounting factors, including the section 846(c) corporate bond yield for interest and US loss payment patterns published by the Secretary.

I. Applicable Authorities and Current Complexities

A. Section 846

Before 1987, for domestic nonlife insurance companies taxable under part II of subchapter L, or domestic life insurance companies taxable under part I of subchapter L with nonlife business, the amount of the deduction for losses incurred under section 832(b)(5) was generally the same as the amount claimed in the National Association of Insurance Commissioners ("**NAIC**") annual statement for losses incurred (to the extent the amount was fair and reasonable). The Tax Reform Act of 1986[7] ("**1986 TRA**"), however, introduced a discounting requirement for unpaid losses under section 832(b)(5).[8] The rationale for requiring discounting is to reduce losses incurred by the assumed investment earnings on unpaid losses and unpaid loss adjustment expenses between the end of the taxable year and the time the loss is paid.[9] Section 846, also added by the 1986 TRA, defines discounted unpaid losses and prescribes the methods by which NAIC annual statement reserves are discounted for US federal tax purposes.[10]

When first enacted by the 1986 TRA, former section 846(c) referenced the mid-term applicable federal rate ("**AFR**") as described in section 1274(d). For taxable years beginning after December

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[6] Note, these issues may also give rise to timing difference that can affect some taxpayers, including in the application of the Subpart F high tax exception (section 954(b)(4)) and the GILTI high-tax exclusion (Treas. Reg. §1.951A-2(c)(7)). However, we do not expect these timing differences to outweigh the benefits and administrative convenience of the solutions discussed below.

Further, the tax reform proposal put forth by the House Ways and Means Committee (*Amendment in the Nature of a Substitute to the Committee Print Offered by Mr. Neal of Massachusetts* (September 13th, 2021) provides a foreign tax credit carryforward mechanism that would blunt the negative impacts of timing differences that may arise.

[7] P.L. 99-514.

[8] Pub. L. No. 99-514, §1022(a).

[9] *See,* Jt. Comm. on Taxation, *General Explanation of the 1986 Tax Reform Act* (1986 Bluebook), pp. 600-602 (JCS-10-87) (May 4, 1987).

[10] *See* Ocasal*, 6720-1st, T.M., U.S. Income Taxation of International Insurance Activities,* Discounting Loss Reserves – Section 846.

31, 2017, the interest rate under section 846 is determined annually by the IRS on the basis of the corporate bond yield curve as defined in section 430(h)(2)(D)(i), determined by substituting "60-month period" for "24-month period" therein.[11]

Prior to 1997 and the enactment of section 954(i), a CFC with a nonlife insurance business would apply domestic rules (e.g. section 846(c)) to its reserves with the modifications laid out in section 953(b), regardless of whether such CFC would qualify as an insurance company under subchapter L if it were a domestic corporation.[12] Once section 954(i) was enacted in 1997, section 953 was amended[13] to reference section 954(i) in defining reserves for the purposes of a CFC with life or nonlife business and Subpart F income, regardless of whether such CFC would qualify as an insurance company under part I or part II of subchapter L if it were a domestic corporation.[14]

As discussed below, section 954(i)(4)(A)(i) references the mid-term AFR and section 1274(d) in defining the appropriate interest rate applicable for reserve computations. Despite the enactment of TCJA and the amendment of section 846(c) to reference the corporate bond yield curve, however, section 954(i)(4)(A)(i) was not updated and continues to reference the mid-term AFR.[15]

B. Section 954(i)(4)

Prior to 1986 TRA, there were exceptions from foreign personal holding company income for income derived from certain investments made by an insurance company.[16] These exceptions were repealed as part of the Tax Reform Act of 1986. Following this repeal,

> Congress was concerned that the 1986 Act's repeal of these exceptions resulted in the extension of the subpart F provisions to income that is neither passive nor easily moveable. The Congress believed that the provision of exceptions from foreign personal holding company income for income from the active conduct of an insurance, banking, financing or similar business is appropriate.[17]

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[11] Section 846(c) as amended by Pub. L. No. 115-97, §13523(a). *See* Notice 2021-60 (October 20th, 2021).

[12] *See* Prop. Reg. §1.953-6(f).

[13] Pub. L. 105-277, §1005(b)(1), (3) (October 21st, 1998).

[14] Section 953(b)(3).

[15] As section 954(i)(4)(B)(i) was not updated as part of TCJA to reference the corporate bond yield in current section 846(c), and because – as discussed below – Notice 2002-69 continues to reference the AFR, we believe, along with certain companies in the life insurance industry (*see* American Council of Life Insurers, *Re: Guidance related to section 954(i) reserves* (March 25th, 2021)), that the AFR continues to be the appropriate interest rate reference in calculating reserves under section 954(i).

[16] Foreign personal holding company income did not include unrelated ordinary and necessary investment income and the unrelated investment income from required surplus. Former §954(h)(1)(B), former §954(h)(1)(C). *See* S. Rep. No. 105-33, at 90 (1997); H.R. Rep. No. 105-220, at 642 (1997) (Conf. Rep.); Former Reg. §1.954-2(d)(4)(i). Former Reg. §1.954-2(d)(4) applied to taxable years of CFCs beginning after December 31, 1975, and for taxable years of U.S. shareholders whose taxable years ended with or within those taxable years of the CFCs. *See also* Ocasal, 6720-1st, T.M., *U.S. Income Taxation of International Insurance Activities*, Former Exceptions to Foreign Personal Holding Company Income.

[17] *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97 at p. 330 (December 17, 1997).

Congress recognized that insurance companies generate income from investments that, while generally treated as passive under Subpart F, is in fact derived in and supports the active conduct of an insurance business and thus, should be exempted from Subpart F.[18] However, Congress also recognized that delineating between income derived in the active conduct of an insurance business, as opposed to passive investment income otherwise earned, would be difficult.

In order to identify the actively generated investment income, Congress needed to isolate the income that was not passive and easily movable.[19] To effectuate this goal, Congress enacted section 954(i). This subsection includes the definition of Qualified Insurance Income[20] and provides rules limiting the amount of exempt investment income for a nonlife insurance business to either: (i) income derived from investments allocable to exempt contracts or of eighty percent of unearned premiums from exempt contracts, or (ii) income from investments of assets allocable to exempt contracts equal to one-third of a CFC's premiums earned on such contracts.[21]

The section 954(i) computation is generally a balance sheet test to determine if a foreign insurance company has excess investments that would cause the investments to give rise to foreign personal holding company income under section 954(c)(1) (i.e., passive Subpart F income) as opposed to income from the active conduct of insurance business exempt under section 954(i).

Section 954(i)(4)(A) contains the rules for a CFC with nonlife business to compute its reserves. The general rule is that a CFC with nonlife business determines its reserves using the same methods it would use if it were subject to tax under subchapter L, except that the interest rate used is calculated in the same manner as the AFR mid-term rate under section 1274(d), and the appropriate foreign loss payment pattern must be used (*see* Notice 2002-69).[22]

C. Notice 2002-69

Because there are no regulations under section 954(i), Notice 2002-69 was issued to provide guidance for determining the interest rates and appropriate foreign loss payment patterns to be used by a CFC in calculating its Qualified Insurance Income under section 954(i) until regulations or other guidance was published. However, Notice 2002-69 remains the only guidance published to date with respect to interest rates and appropriate foreign loss payment patterns for determining Qualified Insurance Income of CFCs.[23] Until regulations are issued under section 954(i), a CFC with nonlife insurance business may rely on Notice 2002-69 to determine the interest rate and appropriate foreign loss patterns for purposes of section 954(i). CFCs with nonlife insurance business also may apply the guidance of Notice 2002-69 to taxable years prior to publication of

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[18] *Id* at p. 333.

[19] Subpart F generally targets passive income that is easily movable to jurisdictions where U.S. tax may be avoided or deferred indefinitely.

[20] Section 954(i)(2).

[21] *Id* at (i)(2)(A), (B)(i), (4). JCS-23-97 at p. 332-333.

[22] Section 954(i)(4)(A)(i)-(ii).

[23] Notice 2002-69, Section I.

Notice 2002-69.[24]

For undiscounted unpaid losses, Notice 2002-69 states that undiscounted unpaid losses are the unpaid losses shown on the annual statement filed by a taxpayer and references section 846(b)(1).[25] Annual statement is defined as the statement approved by the NAIC that a taxpayer files with a state insurance regulatory authority, cross-referencing section 846(f)(3).[26] For a CFC conducting a nonlife insurance business, Notice 2002-69 provides for the use of undiscounted unpaid losses on a CFC's report filed with a foreign regulatory authority; if no such report is filed or if the report filed does not contain this information, a CFC uses the undiscounted unpaid losses reported for financial reporting purposes in the US.[27]

In the context of the appropriate interest rates, Notice 2002-69 references section 954(i)(4)(A) as the controlling provision for a CFC with nonlife insurance business subject to section 954(i) and goes on to reference the section 1274 regulations and the AFR, similar to former section 846.[28] Notice 2002-69 states that the general rule for applicable interest rates for purposes of section 846 is the AFR (defined under section 1274(d) but based on annual compounding).[29] Notice 2002-69 also identifies the AFR as the appropriate interest rate for a CFC conducting a nonlife business.[30]

For domestic insurance companies, and pursuant to Notice 2002-69,[31] the Secretary publishes loss payment patterns annually.[32] For foreign insurance companies, Notice 2002-69 allows a taxpayer, in the context of identifying an appropriate foreign loss payment pattern, to make an election to use loss payment patterns published by the foreign country in which it does business.[33] This election is only available where such foreign loss payment patterns have been submitted to and approved by the Secretary, which increases the administrative difficulty for a taxpayer in determining where and when such payment patterns can be used.

Alternatively, a taxpayer may elect to use its own loss payment patterns for lines of business with sufficient historical information, i.e., at least four years of historical data prior to the year in which the accident occurs.[34] Note, prior to the enactment of TCJA, former section 846(e) provided taxpayers the opportunity to make a similar election for their domestic and nonreinsurance

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[24] Notice 2002-69, Section VII. *See* Ocasal*, 6720-1st, T.M., U.S. Income Taxation of International Insurance Activities,* Notice 2002-69.

[25] Notice 2002-69, Section III. A.

[26] *Id*. Note, this cross-reference is to the former section 846, and the definition of annual statement is now under section 846(e)(3).

[27] Notice 2002-69, Section III. B.

[28] Notice 2002-69, Section IV. A. General Rule.

[29] *Id*.

[30] *Id* at Section IV. A. Applicable Interest Rate For A QIC.

[31] *Id* at Section V. A.

[32] Rev. Proc. 2020-48 (November 4th, 2020).

[33] Notice 2002-69, Section VII. B.

[34] *Id*.

businesses.[35] Following TCJA, section 846 was amended by striking subsection (e), putting into question whether taxpayers may still make the election under Notice 2002-69 for non-domestic insurance businesses conducted by their CFCs.[36]

II. Current Approaches and Proposed Solutions

As discussed above, taxpayers with CFCs conducting nonlife business currently face a myriad set of complexities and uncertainties when attempting to calculate nonlife reserves under section 954(i), including applicable interest rate inconsistencies and loss payment pattern difficulties. The complexities and uncertainties under the current system related to loss payment patterns are: (1) difficulties in obtaining loss payment pattern information from foreign jurisdictions; (2) uncertainty and cost involved in obtaining approval from the IRS where foreign jurisdictions publish loss payment patterns; and (3) difficulty for taxpayers in determining loss payment patterns by each line of business.

From a practical standpoint, a US company would be required to recalculate a CFC's foreign reserves applying US statutory and then US tax concepts, requiring an often-unique set of adjustments for various types of reserves in multiple jurisdictions. While foreign reserves are routinely recalculated for different US reporting systems, the section 954(i)(4)(A) calculation will require adjustments to be layered on a year-by-year, reserve-by-reserve, jurisdiction-by-jurisdiction basis. A separate annual calculation would then be required to determine a jurisdiction specific interest rate based on ambiguous and not readily available market data.

Many countries or currencies do not have well developed corporate bond markets or may not have the full spread of yields necessary to make robust Section 846-style calculations. Smaller data sets may also drive substantial swings in rates from year to year. Similarly, smaller markets will not have substantial data on losses per line of business, particularly for new or novel lines. This is not just a problem for taxpayers seeking to report their reserves, but also makes it difficult for the IRS to audit these items.

The section 954(i) calculation plays a pivotal role for taxpayers with global operations as it is critical in determining a taxpayer's Subpart F income, GILTI, and foreign tax credit profile, frequently the most important international-related US federal tax items. In an effort to provide helpful comments to Treasury and the IRS, we respectfully put forth the following two safe harbor approaches to address these complicated calculations as a means to provide taxpayers a path to file their tax returns in a manner that avoids the complexities and uncertainties outlined. The first safe harbor proposes reliance on foreign statement reserves, and the second safe harbor relies on using reserves reported for financial statement purposes with adjustments that follow domestic discounting factors.

Where the below safe harbor approaches are adopted, other guidance is issued, or taxpayers change their reserve method under future guidance (whether it be the safe harbor solutions proposed below or otherwise), we respectfully suggest such changes be treated as accounting method changes

[35] Former section 846(e)(1)-(3).

[36] Pub. L. No. 115-97, §13523(c).

under section 446 and Treas. Reg. §1.446-1(e) that are included in the List of Automatic Changes in Rev. Proc. 2019-43[37] (and subsequent guidance) to which the automatic change procedures in Rev. Proc. 2015-13[38] (and subsequent guidance) apply. We hope the below safe harbor suggestions serve as a starting point to moving this effort forward, and we look forward to discussing them further with both Treasury and the IRS.

A. Foreign Statement Safe Harbor

When refining section 954(i) and/or Notice 2002-69, we respectfully suggest that Treasury and the IRS consider providing a rule that allows a CFC to use the foreign statement reserves calculated under its local jurisdictions' rules for section 954(i) purposes (the "**Foreign Statement Safe Harbor**"). While consideration should be given to whether certain restrictions should apply in conjunction with this approach, as discussed further below, we believe providing this option would give taxpayers an administrable approach that avoids: (1) the potential complication for some taxpayers of applying domestic reserve concepts (i.e., section 846 and Notice 2002-69) to foreign statement reserves, (2) forcing taxpayers to create or determine reserve concepts (e.g. loss payment patterns) that may not otherwise be available under foreign statutory reserve regimes, and (3) mitigates certain timing differences that may arise.

The use of foreign statement reserves has also been adopted by Treasury and the IRS in similar scenarios. Section 954(i)(4)(C) states that reserves calculated under section 954(i)(4) are capped by a CFC's foreign statement reserves, and a CFC conducting a life insurance business was, prior to the publishing of the Priority Guidance Plan, able to obtain a ruling under section 954(i)(4)(B)(ii) to use its foreign statement reserves for section 954(i) purposes. Additionally, the proposed regulations under section 953 adopted the approach of using foreign statement reserves for a CFC with life insurance business in foreign countries.[39]

From an administrability standpoint, the Foreign Statement Safe Harbor provides an approach that is unlikely to cause an undue burden to implement. Taxpayers and their CFCs are already required to calculate reserves under foreign regulatory regimes, making the applicable information that would be required under section 954(i) readily available. Additionally, the complications that may be present for some taxpayers in applying domestic concepts to foreign statement reserves would not arise, and taxpayers in jurisdictions that do not publish loss payment patterns or other required information would not be forced to create or determine their own calculations for such items. This approach, in turn, also results in an administrable system for Treasury and the IRS as they are not required to audit complicated reserve calculations that mesh a variety of domestic and foreign concepts; but rather, would need only verify that taxpayers are using the same reserve numbers

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[37] November 11th, 2019. Note, a change in basis of computing reserves under section 807(f) for an insurance company with life business, and a change in the composite method for discounting unpaid losses under section 846 for an insurance company with nonlife business are already included on the List of Automatic Changes. *See* Rev. Proc. 2019-43, Sections 26-27.

[38] January 20th, 2015.

[39] Prop. Reg. §1.953-6(d)(1)(iii).

being reported to their CFCs' foreign regulators. Note, these reserves are generally audited for financial statement purposes, providing further assurances of accuracy and reliability.

The mitigation of timing differences is also beneficial; however, due to the short-tail nature of nonlife reserves, these timing differences generally reverse over a short period. Thus, the anticipated result of a regime under the Foreign Statement Safe Harbor is an administrable system for both taxpayers and Treasury and the IRS.

Were the Foreign Statement Safe Harbor adopted, we do note that it may be necessary to accompany the Foreign Statement Safe Harbor with a set of general requirements aimed to ensure that a CFC's foreign regulator is a bona fide insurance regulator. Consideration should be given to: (i) where the regulator derives its grant of authority; (ii) the responsibilities of the regulator, i.e., setting capital solvency, minimum reserves, and actuarial requirements; (iii) the rules and conditions the regulator sets around the conduct of an insurance business and the requirements to be licensed to conduct an insurance business; (iv) how the regulator provides oversight and ensures compliance with its standards; and (v) establishes minimum insurance reserve and actuarial requirements based on commonly accepted actuarial principles. This list is not meant to be exhaustive, but rather, identify some of the primary items that would be relevant in ensuring a CFC has established its reserves under a local regulatory regime run by a bona fide regulator.

We believe that adoption of the Foreign Statement Safe Harbor, coupled with the considerations highlighted above related to foreign insurance regulators, would provide an administrable system based on information already available to taxpayers, Treasury, and the IRS. Adopting such an approach would remove issues currently present in the system and replace it with a reliable and consistent regime applicable equally to each CFC. Thus, we respectfully put forth the Foreign Statement Safe Harbor as a proposed approach for a CFC conducting a nonlife business to calculate reserves under section 954(i).

B. Financial Statement Reserves Safe Harbor

In addition to, or in lieu of, refining guidance under section 954(i) and Notice 2002-69, we respectfully suggest providing an electable safe harbor to taxpayers that allows taxpayers to elect to apply domestic standards under section 846 and loss payment patterns published by the Secretary to Applicable Reserves (defined below) to determine a CFC's reserves under section 954(i) (the "**Financial Statement Reserves Safe Harbor**").

We suggest that taxpayers be able to use, as the reserve base for the Financial Statement Reserves Safe Harbor: (1) reserves reported for GAAP purposes; (2) reserves reported on financial statements prepared under IFRS; or (3) foreign statement reserves filed with a foreign insurance regulator (collectively, the "**Applicable Reserves**"). Note, the suggestion for which reserve calculation is used as a base is not meant to be an ordering rule, but rather, a flexible approach that allows for the use of any reasonable reserve base that reflects a reasonable method and does not distort income. Once an Applicable Reserve is selected, a taxpayer would then use the undiscounted unpaid losses reported with such reserves and discount the reserves using the applicable interest rate in section 846(c) and loss payment patterns published annually by the Secretary.

1. Applicable Reserves

We recommend the use of an Applicable Reserve as the base for the Financial Statement Reserves Safe Harbor as such reserves are often readily available for most taxpayers, generally include undiscounted unpaid losses, and serve as a reliable base against which to apply interest rate and loss payment pattern discounts for section 954(i) purposes. The approach of using the sources suggested for Applicable Reserves has also been adapted in other areas of the Code, related guidance, including Notice 2002-69, recently proposed legislation, and former regulations.[40]

Section 1297 addresses the definition of, and rules related to, passive foreign investment companies ("**PFICs**"). The purpose of section 1297 and the PFIC regime is to identify foreign companies owned by US persons that derive primarily passive income; this assessment is made by looking at the type of income derived, and the assets held, by such foreign corporations. In determining the assets and liabilities held, section 1297 references the foreign corporation's "applicable financial statement", which is defined as a statement for financial reporting purposes: (i) made based on GAAP; (ii) if there is no GAAP statement, based on IFRS; or (iii) if no GAAP or IFRS statement is available, the annual statement filed with the foreign corporation's applicable insurance regulatory body.[41]

In addition to the PFIC regime containing an approach similar to that recommended herein for the Financial Statement Reserves Safe Harbor, i.e., the use of GAAP, IFRS, or foreign statutory reserves, recent proposed legislation in the form of H.R. 5376 also adopts a similar approach. H.R. 5376 proposes a new section 56A, defining adjusted financial statement income.[42] The term adjusted financial statement income is defined as the net income or loss on a taxpayer's "applicable financial statement."[43] Proposed Section 56A(b) defines applicable financial statement by cross-reference to section 451(b)(3). In an approach that mirrors the PFIC regime under section 1297(f)(4)(A), section 451(b)(3) defines an applicable financial statement as: (i) a financial statement prepared in accordance with GAAP; (ii) if no GAAP financial statement is available, a financial statement prepared based on IFRS; and (iii) if no GAAP or IFRS financial statement is available, a financial statement filed by the taxpayer with a regulatory or governmental body specified by the Secretary.

Further, former temporary regulations under section 56 also provide a similar definition of applicable financial statement.[44] Former Treas. Reg. §1.56T-1(c)(1) defines an applicable financial statement as: (i) a financial statement required to be filed with the SEC; (ii) a certified audited financial statement used for credit purposes that is certified by a Certified Public Accountant or a

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[40] *See* Notice 2002-69, Section III. B.; Section 1297(f)(3), (4) (providing for the use of US GAAP financials for determining assets and liabilities of foreign corporations for purposes of certain testing for passive foreign investment company status); *Text of H.R. 5376, Build Back Better Act*, Sec. 56A. Adjusted Financial Statement Income (October 28th, 2021) (cross referencing section 451(b)(3)); Former Treas. Reg. §1.56-1T.

[41] Section 1297(f)(4)(A).

[42] H.R. 5376, Sec. 56A. Adjusted Financial Statement Income.

[43] *Id*.

[44] Former Treas. Reg. §1.56T-1(c)(1).

similar professional in a foreign country; and (iii) a financial statement provided to a government regulator.[45] Therefore, in light of the adoption of a financial statement-based approach in other areas of the Code, proposed legislation, and former regulations, we recommend the Financial Statement Reserves Safe Harbor using Applicable Reserves as the reserve base.

We believe current, proposed, and former statutes and regulations above support the use of Applicable Reserves, as defined herein, for section 954(i) purposes. However, we do not believe Applicable Reserves should be subject to a direct audit or certification requirement similar to that included in section 451(b); but rather, Applicable Reserves should be deemed acceptable where they are either directly audited/certified or ultimately included in a reserve computation that is audited/certified.[46]

We believe making available the Financial Statement Reserves Safe Harbor gives taxpayers a method to calculate reserves under section 954(i) that is based on readily and consistently available information approved and developed by the Financial Accounting Standards Board ("**FASB**"), the Securities and Exchanges Commission ("**SEC**"), the IFRS Foundation, foreign insurance regulators, and domestic insurance regulatory bodies. This will make for an administrable system for taxpayers regardless of where their CFCs operate by providing for consistent reserve factors to be applied across CFCs and jurisdictions. Further, the Financial Statement Reserves Safe Harbor would give taxpayers much needed certainty that their reserve calculations will be respected. In addition to providing an administrable and reliable method for taxpayers, the Financial Statement Reserves Safe Harbor would likewise provide Treasury and the IRS with a regime that is consistent across taxpayers and familiar to the government (i.e., domestic discounting standards).

2. Undiscounted Unpaid Losses

Under the Financial Statement Reserves Safe Harbor, CFCs could use the undiscounted unpaid losses reported for GAAP, IFRS, or foreign statement purposes, depending on the Applicable Reserve chosen in connection with the Financial Statement Reserves Safe Harbor. By matching the source of a CFC's undiscounted unpaid loss amount with the reserve base against which interest rates and loss payment patterns apply, taxpayers have a more consistent reserve calculation, resulting in a more administrable and logical section 954(i) reserve calculation. This,

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[45] *Id* at (c)(1)(i)-(iii).

[46] In a case where the U.S. taxpayer prepares its financial statements on the basis of U.S. GAAP but does not issue separate financial statements that satisfy one of the current "applicable financial statement" criteria in section 451(b), which may include that the statement be "audited" (depending on which governing statutory provision cited), the tie to the "applicable financial statement" standard might foreclose the taxpayer's ability to elect the safe harbor.

An example of this would be a U.S. domestic insurance group that is wholly owned by a foreign parent (e.g. UK, Spain, Japan, etc.) when the U.S. taxpayer furnishes its US GAAP statements (or equivalent general ledger or trial balance figures) to its foreign parent and the foreign parent then converts those into its reporting GAAP (UK, Spain, or Japan) (assuming it has not yet migrated to IFRS) and issues its audited statements to its shareholders or the foreign equivalent of the SEC. The U.S. taxpayer would be covered by reference to section 451(b)(5) covering groups of entities. However, its ultimate reserves which are recorded on its books in US GAAP are not reported in US GAAP in the "applicable financial statement" because they have been converted to another foreign jurisdiction's GAAP (although any measurement difference in most markets would probably not be materially divergent from US GAAP).

in turn, can provide a more transparent and understandable reserve calculation from the government's perspective.

3. Applicable Interest Rate

Under the Financial Statement Reserves Safe Harbor, CFCs would discount their Applicable Reserves using the corporate yield bond method in section 846(c), as published annually. This would provide readily available interest rate information to taxpayers and simplify the calculation for both taxpayers and the government. Additionally, the complications in applying section 954(i)(4)(A)(i) discussed below, including the fact that the required information is not always available in a foreign jurisdiction, would not be present.

4. Applicable Loss Payment Pattern

Taxpayers that elect application of the Financial Statement Reserves Safe Harbor, and the application of section 846(c) interest rates, would be required to apply the domestic loss payment patterns published pursuant to section 846(d)(1) and Notice 2002-69[47] against their Applicable Reserves. For nonlife reserves, patterns regarding claims reporting, settlement and payment vary widely by product type due to the nature of the product itself and the extent to which courts and adjusters are involved. Therefore, the use of a stable pattern by product type would lend more credibility to the discounting process as a whole. In addition, any differences in jurisdiction would be based on data which is less credible and would vary over time. By providing a uniform loss payment pattern approach for CFCs across all jurisdictions, taxpayers will have a reliable methodology that does not require developing their own patterns, and the IRS and Treasury will have familiarity with the loss payment patterns applied, as opposed to having to rely on, and review and approve, loss payment patterns that may or may not be published by a foreign jurisdiction or developed by taxpayers.

As loss payout patterns are not promulgated in every jurisdiction and since company paid data is often sparse, a company may prefer to use a US benchmark payout pattern under the Financial Statement Reserves Safe Harbor. Payout patterns, exchange rates, inflation and interest rates are interdependent. For example, a country with lower inflation rates will have a shorter payout pattern and lower interest rates such that the present value of reserves would be higher than a country with moderate inflation. When this higher reserve is converted to US dollars, the other country's higher inflation rate will result in the higher reserve being deflated back to the same level it might have been if the analysis were done in US dollars using US payment patterns and interest rates. As matching all the elements is essential to avoid distortions, it is more correct to use US parameters for interest when using a US payment pattern and to convert reserves to US dollars when performing this calculation under the Safe Harbor. Because exchange rates, US payout patterns, and US interest rates are readily available, the use of these parameters will promote consistency across jurisdictions and companies and simplicity in application. Moreover, in the event of unusual economic influences in a particular jurisdiction, using the exchange rate will help to correct and avoid inconsistencies. In addition, because of the offsetting influence of the exchange rate, it is

[47] *See* Notice 2002-69. Section V.A and Rev. Proc. 2020-48 (publishing discount factors for the 2020 accident year).

unlikely that there would be any material differences resulting from this approach over using jurisdiction specific parameters.

Additionally, the Secretary must approve the foreign loss payment patterns published by a foreign jurisdiction, removing certainty for taxpayers that, even where a foreign jurisdiction publishes loss payment patterns, such loss payment patterns will be approved by the Secretary for section 954(i) purposes under Notice 2002-69. Further, foreign regulators are under no compulsion to publish loss payment patterns in a timely manner for US Federal tax purposes.

Paid loss development patterns used for actuarial projections would be unavailable/not credible for many classes of business where actuaries rely on incurred losses or market loss ratios. As insurance products, such as cyber, evolve and develop, this type of history will take time to emerge. The improved accuracy gained from country specific data would not be material and may be possibly unreliable in these cases. Thus, by allowing a CFC with nonlife insurance business to use US payment patterns under the Financial Statement Reserves Safe Harbor, Treasury and the IRS will provide taxpayers with an option to compute nonlife reserves based on developed and reliable payout patterns that logically sync with the applicable interest rate under section 846(c).

Providing for the Financial Statement Reserves Safe Harbor would result in a regime with both ease of administration and transparency. By adopting such an approach, Treasury and the IRS would provide taxpayers with a system that can be implemented without undue additional effort coupled with the certainty of an approach sanctioned by Treasury and the IRS. Additionally, Treasury and the IRS would be implementing a system that leverages existing information readily available to taxpayers and the government and vetted by FASB and the SEC, the IFRS Foundation, and local insurance regulators. Therefore, we respectfully put forth the recommendation for the Financial Statement Reserves Safe Harbor.

III. Conclusion

Section 954(i) was enacted in order to prevent investment income derived by insurance companies in the active conduct of an insurance business from being classified as passive, Subpart F income. In order to distinguish actively derived investment income from passive investment income, Congress established an insurance company's reserves, as calculated pursuant to section 954(i), as the appropriate measure. The need for guidance in this area is increasingly urgent as the section 954(i) reserve calculation is central to a taxpayer's ability to determine Subpart F and GILTI income.

Due to the importance of, and urgent need for, this guidance, as well as the issues discussed above, we appreciate the opportunity to provide comments. We believe the proposed safe harbor solutions put forth above, alone or in combination with each other, can serve as a starting point for Treasury and the IRS to address the issues currently present in calculating nonlife reserves under section 954(i). The Foreign Statement Safe Harbor allows taxpayers to rely on readily available foreign statement reserves as their section 954(i) reserve amount, avoiding complex calculations and reserve amounts that are difficult to audit. The Financial Statement Reserves Safe Harbor gives taxpayers flexibility by allowing for the use of a readily available reserve base against which to apply discounting factors that are developed and published annually by the government, resulting in an understandable reserve calculation that can be performed without undue effort. By adopting

the safe harbors proposed above, Treasury and the IRS would provide taxpayers with a section 954(i) regime that provides certainty, flexibility, administrability, and is in-line with the policy goals of section 954(i), i.e., determining the correct measure of reserves required to conduct an active insurance business. In turn, the proposed solutions would give Treasury and the IRS a section 954(i) regime that is less complex and more transparent, while increasing the government's ability to audit these reserve calculations.

We appreciate your consideration of our comments and recommendations discussed in this letter with respect to the calculation of nonlife reserves under section 954(i). If you would like to discuss this letter further, please contact Chris Ocasal at chris.ocasal@ey.com or (202) 327-6868.

Respectfully Submitted,

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