

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

(INTL-939-86)

RIN 1545-AJ70

Insurance Income of a Controlled Foreign Corporation for Taxable Years Beginning After December 31, 1986

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed income tax regulations relating to the definition and computation of the insurance income of a controlled foreign corporation. The proposed regulations also contain definitions and rules applicable to certain captive insurance companies. This action is necessary because of changes to the applicable tax law made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act 1988. These regulations would provide guidance needed to comply with these changes and would affect controlled foreign corporations with income derived from insurance operations.

DATES: Written comments must be received by June 17, 1991. A public hearing on these proposed regulations will be held Monday, June 24, 1991, beginning at 10 a.m. See the notice of public hearing on these proposed regulations elsewhere in this issue of the Federal Register.

ADDRESSES: Send comments to: Commissioner of Internal Revenue, P.O. Box 7604, Ben Franklin Station, Attention: CC-CORP-T:R (INTL-939-86), room 4429, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: David R. Cooper of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, Attention: CC:INTL:Br2 (INTL-939-86) (202-366-6645, not a toll-free call).

SUPPLEMENTARY INFORMATION:**Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent

to the Office of Management and Budget, Attention: Desk Office for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T.F.P., Washington, DC 20224.

The collection of information in these regulations is in §§ 1.953-2(e)(3)(iii), 1.953-4(b), 1.953-5(a), 1.953-6(a), 1.953-7(c)(8), 1.6046-1(a)(2)(i)(c), and 1.6046-1(c)(2)(iii). This information is required by the Internal Revenue Service in order for taxpayers to elect to locate risks with respect to movable property by reference to the location of the property in a prior period; to allocate investment income to a particular category of insurance income; to allocate deductions to a particular category of insurance income; to determine the amount of those items, such as reserves, which are computed with reference to an insurance company's annual statement; to elect to have related person insurance income treated as income effectively connected with the conduct of a United States trade or business; and to collect the information required by section 6046 relating to controlled foreign corporations as defined in section 953(c). The information will be used to verify that locating movable property on the basis of where the property is located in a prior period does not result in a material distortion when compared to where the property is actually located during a current period; to verify the connection between certain items of investment income and a specific category of insurance income; to verify the connection between deductions and a specific category of insurance income; to verify the accuracy of those items which are determined by reference to an insurance company's annual statement; to permit related person insurance income to be taxed at the corporate level as income effectively connected with the conduct of a United States trade or business rather than at the shareholder level as subpart F income; and to ensure compliance with the Internal Revenue Code as it relates to controlled foreign corporations as defined in section 953(c). The likely respondents are business or other for-profit institutions.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on information as is available to the Internal Revenue Service. Individual respondents/recording keepers may require greater or less time, depending on their particular circumstances.

Estimated total annual reporting and recordkeeping burden: 14,100 hours.

The estimated annual burden per respondent and/or recordkeeper varies from 20 to 60 hours, depending on individual circumstances, with an estimated average of 26.2 hours.

Estimated number of respondents and/or recordkeeper: 500.

Estimated annual frequency of responses: Annually.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 953, 954, 954, 1248, and 6048 of the Internal Revenue Code of 1986. These amendments are proposed to conform the regulations to section 1221(b) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2083, 2551) and to section 1012(i) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3342).

Explanation of Provisions

Statutory Provisions

A United States shareholder of a controlled foreign corporation is subject to current United States taxation on the subpart F income of the foreign corporation. Subpart F income is defined under section 952 and consists of several types of income, one of which is "insurance income," as defined in section 953. Insurance income exists only with respect to bona fide contracts of insurance (or reinsurance) or annuity contracts. This regulation does not address the issue of what constitutes insurance. Whether a payment is considered an insurance premium or a contribution to capital can, however, affect both the characterization of receipts as "insurance income" and the value of stock in a controlled foreign corporation owned by United States persons. Therefore, the characterization of payments as insurance premiums or contributions to capital must be considered carefully.

Insurance income is income (including investment income) attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the country under the laws of which the controlled foreign corporation is created or organized and which would be taxed under subchapter L of the Code if the income were the income of a domestic insurance company. Although not within the definition of insurance income under section 953, the investment income attributable to insurance, reinsurance, or annuity contracts covering risks located in the controlled foreign corporation's

country of incorporation may be subject to subpart F as foreign personal holding company income under sections 954(a)(1) and 954(c) of the Code.

Section 953(c) provides special definitions of the terms "United States shareholder" and "controlled foreign corporation" for the purpose of taking into account related person insurance income. Related person insurance income is any insurance income attributable to a policy of insurance or reinsurance under which the insured is a United States shareholder of the controlled foreign corporation or a related person to such a shareholder. For purposes of taking into account related person insurance income, the term "United States shareholder" means any United States person (as defined in section 957(c)) who owns, within the meaning of section 958(a), any stock of the foreign corporation, and the term "controlled foreign corporation" means any foreign corporation if 25 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote, or 25 percent or more of the total value of the stock of the foreign corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of the foreign corporation. A person is related to a United States shareholder if such person is related within the meaning of section 954(d)(3) to the United States shareholder. In addition, in the case of a policy covering liabilities arising from services performed as a director, officer, employee of a corporation, or as a partner or employee of a partnership, the person performing the services and the entity for which the services are performed are related persons.

Section 953(c) contains certain exceptions which, if applicable, relieve United States shareholders (other than United States shareholders as defined in section 951(b)) from having to include related person insurance income in their gross income. Section 953(c) also provides special rules for determining a United States shareholder's pro rata share of related person insurance income and provides for the application of section 1268 to persons who are United States shareholders solely by virtue of section 953(c)(1)(A).

Finally, the statute provides for certain rules preventing the application of certain provisions of subchapter L of the Code in computing insurance income, and provides regulatory authority to prescribe rules for the allocation and apportionment of income,

expenses, losses, and deductions, as well as rules to carry out the purpose of the related person insurance income provisions of section 953(c).

The proposed regulations do not address section 953(d), which permits a foreign insurance company that is a controlled foreign corporation to elect to be treated as a domestic corporation, or section 964(d), which permits a qualified insurance branch of a controlled foreign corporation to be treated as a separate foreign corporation created under the laws of the foreign country. Guidance will be provided under those sections as part of another regulation project. See Notice 89-79, 1989-2 C.B. 392, for interim guidance under section 953(d).

Consideration has been given to whether the definition of the term "life insurance contract" under section 7702(a), the diversification requirements for variable contracts under section 817(h), and the distribution requirements of section 72(s) should be considered applicable for subpart F purposes to contracts issued by controlled foreign corporations conducting insurance operations with nonresident aliens. The proposed regulations contain a reservation on these issues. Comments are invited on them.

Summary of Regulations

Because of the substantial modification of the provisions of section 953 by the Tax Reform Act of 1986, the proposed regulations redraft the current regulations under section 953 in their entirety. In addition, several conforming modifications in the form of proposed regulations are made to the final regulations under sections 954, 904(a), 1248(a), and 6048(a). The regulations are proposed to be applicable to taxable years of controlled foreign corporations beginning after December 31, 1986. However, the amendments to sections 953(c)(2) and 953(c)(3) by sections 1012(i)(3)(A) and 1012(i)(3)(B) of the Technical and Miscellaneous Revenue Act of 1988 are proposed to apply to taxable years beginning after December 31, 1987 to the extent such amendments add the phrase "directly or indirectly)". Further, the new location rules of § 1.953-2 are proposed to apply only to periods of coverage that begin on or after June 17, 1991. Prior to the effective date of § 1.953-2, taxpayers may determine the location of risks by using the principles of § 1.953-2 of the current regulations, but those principles shall be applied to determine where risks are located in or outside the controlled foreign corporation's country of incorporation rather than in or outside the United States. Comments are

invited on whether other transitional rules would be appropriate.

Upon adoption of the proposed regulations as temporary or final regulations, the current regulations under section 953 will be retained (although redesignated as § 1.953-1A through 1.953-8A) because they remain applicable with respect to taxable years of controlled foreign corporations beginning before January 1, 1987. Similarly, several conforming modifications in the form of proposed regulations are made to the final regulations under sections 954, 964(a), 1248(a), and 6048(a).

Section 1.953-1(a) provides definitions of the different categories of insurance income of a controlled foreign corporation that issues insurance, reinsurance, or annuity contracts. Income from a contract covering risks outside the controlled foreign corporation's country of incorporation (the "home country") constitutes insurance income within the meaning of section 953. Income from a contract covering risks in the controlled foreign corporation's home country is income within the same-country insurance category (the "SCI category"). Premiums within the SCI category are generally not considered to be section 953 insurance income and are not includable in the gross income of United States shareholders of a controlled foreign corporation. However, investment income within the SCI category may be subject to inclusion in the gross income of United States shareholders of the controlled foreign corporation as foreign personal holding company income under sections 954(a)(1) and 954(c). Section 1.953-1(a) also defines two categories of section 953 insurance income: income within the RPII category, which is income that constitutes related person insurance income, and income within the nonRPII category, which is all section 953 insurance income other than related person insurance income.

Section 1.953-1(b) provides the procedures that are used to determine the amount of a controlled foreign corporation's section 953 insurance income and its foreign personal holding company income derived from insurance, reinsurance, and annuity contracts. The first step in the procedure is to determine whether premiums constitute section 953 insurance income or SCI income. The second step is to determine whether premiums that constitute section 953 insurance income are attributable to the RPII or nonRPII categories. The third step is to allocate and apportion investment income to the RPII, nonRPII, and SCI categories. The

last step is to allocate and apportion expenses, losses, and other deductions among the RPII, non RPII, and SCI categories, and to allocate and apportion deductions within the SCI category, and in certain circumstances within the RPII category, between premium and investment income.

Section 1.953-2 provides rules for determining whether premiums are attributable to the section 953 insurance income or SCI income categories. That determination is made by locating the risks covered by an insurance, reinsurance, or annuity contract during the period of coverage to which the premiums under the contract relate. Premiums written before the first taxable year of a controlled foreign corporation beginning after December 31, 1986 that become earned under section 832(b)(4) in such taxable year or succeeding taxable years must be classified as either section 953 insurance income or SCI income.

Section 1.953-2(d) provides general rules of allocation and apportionment of premiums to or between the section 953 insurance income category and the SCI income category where an insurance, reinsurance, or annuity contract covers risks both in and outside the home country. Section 1.953-2(d) also provides that if 80 percent or more of the premiums under a contract of insurance or reinsurance or an annuity contract are apportioned to risks in or outside the home country, then all of the premiums are attributed to risks in or outside the home country, respectively.

Section 1.953-2(e) sets forth specific rules for locating risks in connection with property. Such risks are generally located where the property is located during the period or periods of coverage under the contract of insurance or reinsurance that are applicable to a taxable year. Specific rules are provided for determining the location of commercial transportation property, noncommercial transportation property, property exported or imported by railroad or motor vehicle, property exported or imported by ship or aircraft, and shipments originating and terminating in or outside the home country. Specific rules are also provided for allocating and apportioning premiums when the contract of insurance or reinsurance covers many related items or property, such as inventory, which may be both in and outside the home country. In order to aid a controlled foreign corporation that is not able to determine the location of moveable property as of the close of its taxable year, a specific rule is also set

forth for locating risks in connection with such property.

Section 1.953-2(f) provides specific rules for locating risks in connection with liability arising out of activities. Generally, such risks are located where the activities that could give rise to the liability are performed. Specific rules are provided for locating activities with respect to liabilities arising from the use or consumption of property that is manufactured, produced, constructed, or assembled by the insured. Specific rules are also provided for determining the location of activities in connection with transportation property and selling activities.

Section 1.953-2(g) sets forth rules for locating risks in connection with contracts of insurance or reinsurance covering life or health. This section also covers the location of risks under annuity contracts, whether life annuities or annuities certain. Such risks are generally located in the country of the residence of the person with the "determining life." For a contract of insurance or reinsurance providing protection against loss of life or health, the determining life is the person whose life or health is covered by the contract. For a life annuity, or a contract reinsuring life annuities, the determining life is the person by whose life the annuity payments are measured. For an annuity certain, or a contract reinsuring annuities certain, both the purchaser of the annuity and the beneficiary of the annuity payments are the appropriate determining lives. If either the purchaser or beneficiary of an annuity certain resides outside the home country, the premiums received with respect to the annuity constitute section 952 insurance income. The residence of the person with the determining life is generally determined by the address of such person that is provided to the insurer. Finally, section 1.953-2(h) provides rules for determining the location of risks in certain direct or indirect cross-insurance arrangements.

Section 1.953-3 contains the rules for distinguishing RPII premiums for nonRPII premiums. Section 1.953-3(a) states that RPII premiums are section 953 insurance income premiums that constitute related person insurance income.

Section 1.953-3(b) defines related person insurance income. Related person insurance income is included within the meaning of the term "insurance income" as that term is used in section 953 of the Code. Related person insurance income is defined as premium and investment income attributable to a policy of insurance or

reinsurance that provides insurance coverage to a related insured on risks located outside the controlled foreign corporation's country of incorporation, or premium and investment income attributable to any annuity contract that is purchased by, or for the benefit of, a related insured if the determining life is located outside the controlled foreign corporation's country of incorporation. For this purpose, a related insured is any insured, purchaser of an annuity contract, or beneficiary under an annuity contract that is a United States shareholder of the controlled foreign corporation or a related person (within the meaning of section 954(d)(3)) to a United States shareholder. In addition, in the case of any policy of insurance covering liability arising from services performed as a director, officer, or employee of a corporation, or as a partner or employee of a partnership, the person performing such services and the entity for which such services are performed shall be treated as related persons. Related person insurance income also includes income attributable to contracts reinsuring and contracts indirectly insuring related insureds if the risks under the contract are located outside the controlled foreign corporation's country of incorporation.

For purposes only of taking related person insurance income into account, the terms "United States shareholder" and "controlled foreign corporation" are specially defined in § 1.953-3(b). An exception from the modified definition of United States shareholder is provided for persons who would be United States shareholders of an insuring foreign corporation as a result of their ownership of stock in another foreign corporation if the stock of the other foreign corporation is publicly traded, the United States person owns less than five percent of such foreign corporation's stock and the stock of the insuring foreign corporation constitutes less than five percent of the total value of all assets of such foreign corporation. Section 1.953-3(b) also provides that related person insurance income includes insurance income attributable to certain direct or indirect cross-insurance arrangements.

Section 1.953-3(b) also provides rules for determining whether premiums constitute related person insurance premiums under certain specific circumstances. Premiums received prior to December 31, 1986 which become earned in the controlled foreign corporation's first taxable year beginning after December 31, 1986, or any succeeding taxable year, may

constitute related person insurance income. Rules are also provided for computing RPII premiums when the related insured owns stock for less than the entire taxable year. An anti-abuse rule states that capital contributions may be recharacterized as premiums in certain circumstances.

Section 1.953-4 provides guidance concerning the allocation and apportionment of items of investment income to or among the RPII, nonRPII, and SCI categories. An item of investment income is allocated to a particular category of income if it directly relates to a contract which gives rise to premiums allocable to that category. An item of investment income is considered directly related to a contract which gives rise to premiums within a particular category if the income is derived from an asset which is identified on the controlled foreign corporation's books and records as an asset relating to RPII, nonRPII, or SCI contracts and the controlled foreign corporation separately accounts for the various income, exclusion, deduction, reserve, and other liability items properly attributable to such contracts. If investment income cannot be allocated, it is apportioned among the various categories of income in accordance with apportionment formulas provided in § 1.953-4(c).

Section 1.953-5(a) provides rules for allocating expenses, losses, and other deductions among the RPII, nonRPII, and SCI categories. Allocation of deductions generally is made in accordance with §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T of the regulations. Specific rules are provided to allocate reserve deductions and deductions for claims, benefits, and losses. Deductions that cannot be allocated are apportioned among the various categories in accordance with the rules provided in § 1.953-5(b), which are generally consistent with the principles of §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T. Under § 1.953-5(b), deductions that are allocated or apportioned to investment income pursuant to the regulations under section 861 are apportioned among the various income categories in the same manner as investment income. Other deductions that are not allocated or apportioned to investment income pursuant to the regulations under section 861 are apportioned among the various income categories in accordance with the amount of premium income, adjusted by increases or decreases in reserves, in each category.

Section 1.953-5(c) provides rules for allocating and apportioning deductions

to or between premium and investment income within the SCI and, in certain circumstances, within the RPII categories. Although deductions other than those for reserves, losses, and specified policy acquisition expenses are allocated and apportioned between investment and premium income by following the principles of §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T, specific rules are provided under § 1.953-5(c)(3) for apportioning reserves, losses, and specified policy acquisition expenses between investment and premium income for taxable years beginning on or after April 17, 1991. The method prescribed for apportioning reserves between premium and investment income is based on the assumptions that premiums are received and losses paid at mid-year, and that the investment income portion of the increase in reserves can be calculated by assuming the reserves earn investment income at the interest rate used to calculate tax reserves. For taxable years beginning prior to April 17, 1991, taxpayers may use a reasonable apportionment formula. However, in most cases, a method that apportions reserves and losses between premium and investment income based on the ratio of premium or investment income to total income will not be considered a reasonable apportionment.

Section 1.953-6 contains provisions relating to the application of subchapter L and certain sections of subchapter N of the Code. Section 1.953-6(a) states that the provisions of subchapter L are generally applicable in determining the amount of a controlled foreign corporation's section 953 insurance income and SCI investment income to be included in gross income. Section 1.953-6(b) lists the provisions of subchapter L which are not applicable. Section 1.953-6(c) contains rules for making the election under section 831(b) to be taxed on investment income only. A section 831(b) election is a corporate level election and therefore can be made only by a controlled foreign corporation that has made the election under § 1.953-7(c) to have its related person insurance income taxed as income effectively connected with the conduct of a trade or business within the United States. Section 1.953-6(d) contains rules necessary to determine whether a controlled foreign corporation is subject to the rules of part I of subchapter L of the Code relating to life insurance companies. Section 1.953-6(e) provides specific rules relating to the computation of the reserves of a controlled foreign corporation. Section 1.953-6(f) states that a controlled foreign corporation

that would not be taxable as an insurance company if it were a domestic corporation is nevertheless subject to section 953 and prescribes rules for determining the insurance income of such a corporation. Section 1.953-6(g) describes the relationship between sections 953 and 954. Section 1.953-6(h) provides rules for computing a United States shareholder's pro rata share of section 953 insurance income. Section 1.953-6(i) states that section 959 (exclusion from gross income of previously taxed earnings and profits), section 961 (adjustment to basis in stock in controlled foreign corporations and of other property), and section 1248 (gains from certain sales or exchanges of stock in certain foreign corporations) are applicable to persons who would not be United States shareholders but for section 953(c) and § 1.953-3(b)(2)(i). Section 1.953-6(k) provides that income that is subject to subpart F solely by virtue of the full inclusion rule of section 954(b)(3)(B) is not considered related person insurance income and need not be included in the gross income of persons that are not United States shareholders within the meaning of section 951(b).

Section 1.953-7 sets forth the exceptions to inclusion of related person insurance income by persons who are not United States shareholders under section 951(b). Section 1.953-7(c) provides rules relating to the exception that applies if less than 20 percent of the stock of a controlled foreign corporation is owned by insureds. Section 1.953-7(b) relates to the exception for a controlled foreign corporation with a de minimis amount of related person insurance income. Section 1.953-7(c) provides rules and procedures for an election by a corporation that is a controlled foreign corporation solely by virtue of section 953(c), to have its related person insurance income treated as if it were effectively connected with a United States trade or business. To make an election, the controlled foreign corporation must waive treaty benefits, except for benefits with respect to section 884, must timely file an election statement, must enter a closing agreement with the Internal Revenue Service, and must provide an adequate letter of credit.

These proposed regulations would amend the temporary regulations under § 1.954-1T(c) to state that a controlled foreign corporation with foreign base company income derived from insurance operations allocates and apportions deductions in accordance with § 1.953-5. These proposed regulations also would amend § 1.964-1(c)(5) to identify those

shareholders who are the controlling United States shareholders of a foreign corporation that is a controlled foreign corporation solely by virtue of section 953(c)(1) for purposes of making elections on behalf of the controlled foreign corporation. In addition, these proposed regulations would amend the final regulations under section 1248(a) to make clear the application of section 1248 to persons that are United States shareholders by virtue of section 953(c). Finally, these proposed regulations also would amend the regulations under section 6046(a) to make the reporting requirements of that section applicable to persons that are United States shareholders by virtue of section 953(c).

With certain exceptions, the proposed regulations do not draw a distinction between mutual insurance companies and stock insurance companies.

However, the Internal Revenue Service is interested in receiving comments relating to application of the rules of this regulation with respect to mutual insurance companies and, in particular, whether certain mutual insurance companies should be excluded from the provisions of section 953 and the criteria for such an exclusion.

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a regulatory impact analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) and the Regulatory Flexibility Act (5 U.S.C. Chapter 6) do not apply to these regulations, and, therefore, an initial regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying.

A public hearing will be held on Monday, June 24, 1991, beginning at 10 a.m. in the Internal Revenue Service Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. For further information, see the notice of public hearing on these proposed regulations in

the Proposed Rules section of this issue of the Federal Register.

Drafting Information

The principal author of these proposed regulations is Philip L. Gariett formerly of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from the Internal Revenue Service and Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.861-1 through 1.997-1

Income taxes, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, FSC, Sources of income, U.S. investments abroad.

26 CFR 1.1201 through 1.1252-2

Income taxes, Capital gains and losses, Recapture.

26 CFR 1.6001-1 through 1.6109-2

Income taxes, Administration and procedure, Filing requirements.

26 CFR Part 602

Recording and recordkeeping requirements.

Proposed amendments to the regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority for part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. Sections 1.953-1 through 1.953-2 also issued under 26 U.S.C. 953(b)(3). Section 1.953-3 also issued under 26 U.S.C. 953(b)(3) and (c); 8 (A) and (B). Section 1.953-6 also issued under 26 U.S.C. 953 (b)(3) and (c); 5(D). Section 1.953-7 also issued under 26 U.S.C. 953(c)(3).

§§ 1.953-1 through 1.953-6 (Redesignated as §§ 1.953-1A through 1.953-6A)

Par. 2. Sections 1.953-1 through 1.953-6 are redesignated as §§ 1.953-1A through 1.953-6A and a new center heading is added preceding newly designated § 1.953-1A to read as follows:

Regulations Applicable to Taxable Years Beginning Before January 1, 1967

Par. 3. A new center heading and new §§ 1.953-0 through 1.953-7 are added to read as follows:

Regulations Applicable to Taxable Years Beginning After December 31, 1988

§ 1.953-0 Introduction.

(a) This paragraph lists the topics covered in §§ 1.953-0 through 1.953-7.

§ 1.953-0 Introduction.

- (a) Outline.
(b) Effective dates.

§ 1.953-1 Taxation of foreign insurance operations.

- (a) In general.
(b) Determining subpart F inclusions of income from insurance operations.
(1) Procedure.
(2) Cross reference to additional provisions.
(c) Effective date.

§ 1.953-2 Premiums attributable to the section 953 insurance income category and the SCI income category.

- (a) In general.
(1) Section 953 insurance income premiums.
(2) SCI income premiums.
(b) Method of attributing premiums to the section 953 insurance income or SCI income categories.

- (1) In general.
(2) Examples.
(c) Definition of premium.
(d) Allocation and apportionment of premiums.

(1) Risks both in and outside the home country.

(2) Examples.

(3) 80 percent rule.

(i) In general.

(ii) Example.

(e) Location of risks in connection with property.

(1) In general.

(2) Specific rules for locating certain types of property.

(i) Commercial transportation property.

(ii) Examples.

(iii) Noncommercial transportation property.

(iv) Property exported by ship or aircraft.

(v) Property imported by ship or aircraft.

(vi) Shipments originating and terminating in the home country.

(vii) Shipments originating and terminating in a country other than the home country.

(3) Related assets and certain moveable property.

(i) Related assets.

(ii) Example.

(iii) Moveable property.

(iv) Example.

(f) Location of risks in connection with liability arising out of activity.

(1) Definition of risks in connection with liability.

(2) Location of risk.

(i) In general.

(ii) Examples.

(3) Specific rules locating certain activities.

(i) Liability with respect to property manufactured, produced, constructed, or assembled.

(ii) Examples.

(iii) Location of activities in connection with transportation property.

- (iv) Example.
(v) Sailing activity.
(vi) Example.
(g) Location of risks in connection with life or health.

(1) In general.

(2) Example.

(b) Risks deemed to be located in a country other than the home country.

(1) Artificial arrangements.

(2) Evidence of arrangements.

(3) Examples.

§ 1.953-3 Allocation of premiums to the RPII or nonRPII categories of section 953 insurance income.

(a) In general.

(b) Related person insurance income.

(3) In general.

(2) Definitions.

(i) United States shareholder, related person, and controlled foreign corporation.

(ii) Examples.

(iii) United States shareholder: exception for indirect ownership; publicly traded stock.

(iv) Example.

(v) Controlled foreign corporation: shipowner's protection and indemnity association.

(3) Reinsurance.

(i) In general.

(ii) Examples.

(4) Indirectly insuring a related insured: fronting.

(i) In general.

(ii) Example.

(3) Cross-insurance arrangements.

(i) In general.

(ii) Example.

(8) Specific premium rules.

(1) Premiums received prior to January 1, 1987.

(ii) Apportionment of premiums if stock owned for less than entire taxable year.

(iii) Examples.

(iv) Anti-abuse rule.

(v) Example.

§ 1.953-4 Allocation and apportionment of items of investment income.

(a) In general.

(1) Investment income.

(2) Decreases in reserves.

(i) In general.

(ii) Examples.

(b) Allocation of investment income.

(1) In general.

(2) Examples.

(c) Apportionment of investment income.

(1) Life insurance companies.

(i) In general.

(ii) Section 807(c) items attributable to RPII, nonRPII, and SCI contracts.

(2) Property and casualty companies.

(i) In general.

(ii) Unpaid losses attributable to a particular category.

(3) Examples.

§ 1.953-5 Allocation and apportionment of expenses.

(a) Allocation of deductions to RPII, nonRPII, and SCI categories.

(b) Apportionment of expenses to RPII, nonRPII, and SCI categories.

(1) In general.

(2) Life insurance companies.

- (i) Investment deductions.
(ii) Other deductions.
(3) Property and casualty companies.
(i) Investment deductions.
(ii) Other deductions.

(c) Allocation and apportionment of deductions between premium and investment income after the deductions have been allocated or apportioned to the SCI or RPII categories.

(1) In general.

(2) Examples.

(3) Apportionment of reserves, losses, policyholder dividends, and policy acquisition expenses and certain other deductions between investment and premium income.

(i) In general.

(ii) Deduction for reserves and losses defined.

(iii) Investment income required to be added to reserves and required to fund losses.

(iv) Investment income's proportionate share of policyholder dividends.

(v) Apportionment of policy acquisition expenses and certain other deductions.

(vi) Example.

(4) Alternative method for life insurance companies.

(i) In general.

(ii) Example.

(3) Losses in excess of premium or investment income.

(8) Losses within the RPII, nonRPII, and SCI categories.

§ 1.953-6 Application of subchapter L and certain sections of subchapter N of the Code.

(a) Applicability of subchapter L.

(1) In general.

(2) Applicability of section 7702. [Reserved]

(3) Applicability of section 817. [Reserved]

(b) Special rules regarding use of subchapter L to compute RPII, nonRPII, and SCI income.

(1) Certain provisions not to apply.

(2) Allocation and apportionment of certain items.

(c) Alternative tax for certain small companies.

(d) Computation of reserves to determine applicability of part I of subchapter L.

(3) Reserves required by law.

(i) Reserves with respect to United States business.

(ii) Reserves deemed to be required.

(iii) Reserves with respect to foreign business.

(2) SCI reserves to be taken into account.

(e) Computation of reserves for purposes of computing taxable income.

(1) Actual reserves required.

(2) Life insurance reserves.

(3) Discounted unpaid losses of a property and casualty company.

(4) Interest rates used for determining reserves.

(i) Qualified foreign contracts and property and liability contracts.

(ii) Nonqualified foreign contracts.

(f) Corporations not qualifying as insurance companies.

(1) In general.

(2) Items of gross income attributable to insurance operations of a non-insurance company.

(i) Corporations computing taxable income under part I of subchapter L.

(ii) Example.

(iii) Corporations computing taxable income under part II of subchapter L.

(g) Relationship between sections 953 and 554.

(1) Priority of application.

(i) In general.

(ii) Examples.

(2) Decrease or increase in income not material.

(i) In general.

(ii) Examples.

(h) Inclusion of pro rata share of subpart F income derived from insurance operations.

(1) Inclusion of pro rata share of related person insurance income.

(2) Inclusion of subpart F income other than related person insurance income.

(3) Earnings and profits limitation.

(4) Examples.

(5) Controlled foreign corporation for less than entire year.

(i) In general.

(ii) Example.

(6) Distributions.

(i) In general.

(ii) Example.

(7) Mutual insurance companies.

(i) Application of sections 959, 961, and 1248.

(j) Application of section 367(b). [Reserved]

(k) Interaction with section 954(b)(3).

§ 1.953-7 Exceptions to inclusion of related person insurance income for certain shareholders.

(a) Corporation not held by insureds.

(1) In general.

(2) Examples.

(d) De minimis insurance exception.

(1) In general.

(2) Examples.

(3) Anti-abuse rule.

(i) In general.

(ii) Examples.

(c) Election to treat income as effectively connected.

(1) In general.

(2) Corporations which may make the election.

(i) In general.

(ii) Successor corporation.

(iii) Examples.

(3) Taxable year of corporation making election.

(4) Period during which election is in effect.

(i) Elections that become effective in taxable years beginning after December 31, 1987.

(ii) Examples.

(ii) Elections that become effective in first taxable year beginning after December 31, 1988.

(iv) Examples.

(5) Effect of election: taxation under section 862; alternative minimum tax; dividends received deduction; pre-1987 deficits in earnings and profits; and net operating losses.

(6) Exemption from tax imposed by section 4371.

(7) Procedure for making election under section 953(c)(3)(C).

(i) In general.

(ii) When election must be made.

(iii) Election.

(8) Closing agreement.

(9) Letter of credit.

(i) In general.

(ii) Changes in the amount of the letter of credit.

(10) Underpayment of tax due.

(11) Termination or revocation of election.

(i) Termination.

(ii) Revocation with consent.

(iii) Unilateral revocation by Commissioner.

(b) *Effective dates.* (1) The provisions of §§ 1.953-1 through 1.953-7 apply to taxable years of a controlled foreign corporation beginning after December 31, 1986. However, the amendments to section 953 (c)(2) and (c)(3) by section 1012(i)(3) (A) and (B) (i) and (ii) of the Technical and Miscellaneous Revenue Act of 1988 shall apply to taxable years beginning after December 31, 1987 to the extent such amendments add the phrase "directly or indirectly." Further, the risk location rules of § 1.953-2 shall apply only to periods of coverage that begin on or after June 17, 1991. Prior to the effective date of § 1.953-2, taxpayers may determine the location of risks by using the principles of § 1.953-2A of the regulations, but those principles shall be applied to determine whether risks are located in or outside the controlled foreign corporation's country of incorporation rather than in or outside the United States. Finally, the apportionment of reserves, losses, policyholder dividends, and policy acquisition expenses between premium and investment income within the SCI, and, in certain circumstances, within the RPII category as provided in § 1.953-5(c)(3) shall apply to taxable years beginning on or after April 17, 1991. For taxable years beginning prior to April 17, 1991, taxpayers may use a reasonable apportionment formula.

(2) The provisions of §§ 1.953-1A through 1.953-8A apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

§ 1.953-1 Taxation of foreign insurance operations.

(a) *In general.* The income from the insurance operations of a controlled foreign corporation may be subject to inclusion in the gross income of a United States shareholder under subpart F of the Code either as insurance income under section 953 or as foreign personal holding company income under section 954 (a)(1) and (c). Section 953 insurance income is income (including premium

and investment income) attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the country (the "home country") under the laws of which the controlled foreign corporation is created or organized and which would be taxed under subchapter L of the Code if the income were the income of a domestic insurance company. The term "home country" includes any area within the jurisdiction (as recognized by the United States) of the country of incorporation of a controlled foreign corporation or within the jurisdiction of a possession of such country. A risk is located in a country other than the home country if it is located on the high seas outside the home country. Insurance income exists only with respect to bona fide contracts of insurance (or reinsurance) or annuity contracts. There are two categories of section 953 insurance income: income that constitutes related person insurance income under § 1.953-3(b)(1) (the "RPII category") and income that is subject to section 953 but is not related person insurance income (the "nonRPII category"). Income, whether premium or investment income, derived from issuing or reinsuring insurance or annuity contracts in connection with risks located in the country in which the controlled foreign corporation is created or organized is referred to as same country insurance ("SCI") income. Investment income attributable to premiums that constitute SCI income may be includable in the gross income of the United States shareholders of a controlled foreign corporation as foreign personal holding company income under sections 954 (a)(1) and (c). However, the premiums attributable to issuing or reinsuring insurance or annuity contracts in connection with risks located in the controlled foreign corporation's home country are not generally treated as subpart F income.

(b) *Determining subpart F inclusions of income from insurance operations—*

(1) *Procedure.* The following procedures are used to determine the amount of a controlled foreign corporation's section 953 insurance income and its foreign personal holding company income derived from insurance operations:

(i) Determine whether premiums from insurance, reinsurance, and annuity contracts issued by the controlled foreign corporation constitute section 953 insurance income or SCI income by determining the location of the risks under the contracts (see § 1.953-2).

(ii) Determine whether the premiums that constitute section 953 insurance

income are attributable to the RPII or nonRPII categories (see § 1.953-3);

(iii) Allocate and apportion investment income to the RPII, nonRPII, and SCI categories (see § 1.953-4); and

(iv) Allocate and apportion deductions to the RPII, nonRPII, and SCI categories; within the SCI category and, under certain circumstances, within the RPII category, further allocate and apportion deductions between SCI premium income and SCI investment income (see § 1.953-5).

(2) *Cross reference to additional provisions.* Section 1.953-6 contains rules relating to the application of subchapter L of the Code (insurance companies), subpart F of part III of subchapter N (controlled foreign corporations), and certain additional Code provisions to income derived from the conduct of insurance operations. Section 1.953-7 contains rules regarding certain exceptions to the inclusion of related person insurance income in the gross income of certain United States shareholders.

(c) *Effective date.* For regulations under section 953 that apply to the taxable years of a controlled foreign corporation beginning before January 1, 1987, see §§ 1.953-1A through 1.953-6A. The provisions of § 1.953-1 and §§ 1.953-3 through 1.953-7 apply to the taxable years of a controlled foreign corporation beginning after December 31, 1986. However, the amendments to section 953 (c)(2) and (c)(3) by section 1012(i)(3) (A) and (B) (i) and (ii) of the Technical and Miscellaneous Revenue Act of 1988 shall apply to taxable years beginning after December 31, 1987 to the extent such amendments add the phrase "(directly or indirectly)." Also, the regulations under § 1.953-2 regarding the location of risks will apply only to periods of coverage, regardless of when the contract was issued, that begin on or after June 17, 1991. Prior to the effective date of § 1.953-2, taxpayers may determine the location of risks by using the principles of § 1.953-2A of the regulations, but those principles shall be applied to determine whether risks are located in or outside the controlled foreign corporation's country of incorporation rather than in or outside the United States. Finally, the apportionment of reserves, losses, policyholder dividends, and policy acquisition expenses between premium and investment income within the SCI and, in certain circumstances, within the RPII category as provided in § 1.953-5(c)(3) shall apply to taxable years beginning on or after April 17, 1991. For taxable years beginning prior to April 17, 1991, taxpayers may use a reasonable apportionment formula.

§ 1.953-2 Premiums attributable to the section 953 insurance income category and the SCI income category.

(a) *In general.* Premiums on any insurance, reinsurance, or any annuity contract (including an annuity certain, which is an annuity that guarantees payments for a fixed period without reference to life contingencies) must be classified as either section 953 insurance income or SCI income. To determine whether premiums paid for an annuity certain are section 953 insurance income or SCI income, the annuity certain shall be treated as a contract covering risks in connection with life or health. Premiums written (less return premiums and premiums paid for reinsurance) before the first taxable year of the controlled foreign corporation beginning after December 31, 1986 that become earned under section 932(b)(4) in such taxable year or succeeding taxable years must be classified as either section 953 insurance income or SCI income. (See § 1.953-3, below, for rules allocating premiums that constitute section 953 insurance income to the RPII or nonRPII categories.)

(1) *Section 953 insurance income premiums.* Premiums constitute section 953 insurance income if they relate to risks that are—

(i) In connection with property located in a country other than the home country, as described in paragraph (e) of this section;

(ii) In connection with a liability arising out of an activity conducted in a country other than the home country, as described in paragraph (f) of this section;

(iii) In connection with the life or health of a resident of a country other than the home country, as described in paragraph (g) of this section; or

(iv) In connection with risks not described in paragraph (e)(1) (i) through (iii) of this section as a result of any arrangement whereby another person receives a substantially equal amount of premiums or other consideration in respect of issuing (or reinsuring) a contract described in paragraph (e)(1) (i) through (iii) of this section. (See paragraph (h) of this section.)

(2) *SCI income premiums.* Premiums constitute SCI income if they relate to risks that are—

(i) In connection with property located in the home country, as described in paragraph (e) of this section;

(ii) In connection with a liability arising out of an activity conducted in the home country, as described in paragraph (f) of this section; or

(iii) In connection with the life or health of a resident of the home country,

as described in paragraph (g) of this section.

(b) *Method of attributing premiums to the section 953 insurance income or SCI income categories—(1) In general.* Whether the premiums from an insurance, reinsurance, or annuity contract constitute section 953 insurance income or SCI income is determined by the location of the risks during the period or periods of coverage under the contract to which the premiums relate. A period of coverage is a period no longer than one year during which insurance coverage is provided or an annuity contract is in force and which begins or ends with or within the taxable year of the controlled foreign corporation. A period of coverage begins when coverage under the contract commences or on the anniversary of that date. A period of coverage ends on the last day preceding a new period of coverage, on the day the contract terminates or is canceled, or on the day the risk under the contract has been transferred in a reinsurance transaction in which the reinsurer assumes all rights and obligations under the reinsured policies. The determination of where a risk is located must be made separately for each period of coverage applicable to the taxable year.

(2) *Examples.* The following examples illustrate the principles of paragraph (b)(1) of this section.

Example 1. Controlled foreign corporation X, incorporated in country M, issues to corporation Z an insurance contract which provides coverage for a 2½ year period beginning on July 1, 1987. Under the insurance contract, premiums are paid monthly. Corporation X uses the calendar year as the taxable year. For premiums included in gross income for the 1987 taxable year, the period of coverage under the contract is July 1, 1987 to June 30, 1988. For premiums included in gross income for the 1988 taxable year, there are two applicable periods of coverage: July 1, 1987 to June 30, 1988 and July 1, 1988 to June 30, 1989. Whether the premiums attributable to each such period of coverage constitute section 953 insurance income or SCI insurance income must be made by considering only the facts pertinent to each period of coverage separately. For the 1988 taxable year, the periods of coverage are July 1, 1988 to June 30, 1989 and July 1, 1989 to December 31, 1989. Again, whether the premiums attributable to each such period of coverage constitute section 953 insurance income or SCI insurance income must be made by considering only the facts pertinent to each period of coverage separately.

Example 2. The facts are the same as in Example 1 except that Z cancels the contract on August 31, 1987. For the 1987 taxable year, the period of coverage is July 1, 1987 to August 31, 1987.

Example 3. The facts are the same as in *Example 1* except that on January 15, 1989, X ceases risks under the insurance contract in a reinsurance transaction (other than a reinsurance transaction in which the reinsurer assumes all rights and obligations under the reinsured contracts) to controlled foreign corporation W, which also uses the calendar year as the taxable year. For the 1988 taxable year, the periods of coverage for X are July 1, 1987 to June 30, 1988 and July 1, 1988 to June 30, 1989. For 1989, the periods of coverage for both X and W are July 1, 1988 to June 30, 1989 and July 1, 1989 to December 31, 1989.

Example 4. The facts are the same as in *Example 1* except that corporation X issues to corporation Z an insurance contract which covers the marine risks of shipping a machine to and from countries other than country M. The contract does not specify the dates during which the machine is covered, but provides coverage from the time the machine is delivered alongside a named vessel at the port of embarkation until the time the machine is delivered alongside the vessel at the port of debarkation. The deliveries are commenced and completed during the period beginning February 1, 1987 and ending February 28, 1987. For the 1987 taxable year, the period of coverage is February 1 to February 28, 1987.

(c) *Definition of premiums.* For a controlled foreign corporation that would be taxed as a life insurance company under part I of subchapter L (relating to life insurance companies) of the Code if it were a domestic insurance company, the term "premiums," for purposes of this section and § 1.953-3, means the items taken into account for the taxable year under section 803(a)(1). For a controlled foreign corporation that would be taxed under part II of subchapter L (relating to insurance companies other than life insurance companies), the term "premiums," for purposes of this section and § 1.953-3, means premiums written, as defined in section 832(b)(4)(A). If a policy of insurance, such as a reporting form policy or other policy, does not require premiums to be paid until the policy term expires, then the deposits required during the term of the policy must be included in premiums. In the case of a mutual fire or flood insurance company described in section 832(b)(1)(D), the term "premiums," for purposes of this section and § 1.953-3, means the entire amount of premiums deposited. In addition, for taxable years beginning after December 31, 1986 and before January 1, 1993, if the foreign corporation was a controlled foreign corporation (as defined in section 957 of the Code prior to its amendment by the Tax Reform Act of 1986) in the most recent taxable year beginning before January 1, 1987, the term "premiums" also includes an amount equal to 3 1/2

percent of the unearned premiums at the end of the most recent taxable year beginning before January 1, 1987 that are sourced within the United States under section 861(A)(7). See section 832(b)(4)(c). Premiums included in gross income by virtue of the preceding sentence are attributable to risks located outside the controlled foreign corporation's home country.

(d) *Allocation and apportionment of premiums—(1) Risks both in and outside the home country.* If the risks covered by a contract of insurance or reinsurance or annuity contract are located both in and outside the home country during any period of coverage, the premium for insuring the risks must be allocated to or apportioned between risks incurred in the home country and risks incurred outside the home country. Allocation of a premium means that there is a direct correlation between the premium charged and the location of the insured risks in or outside the home country. Apportionment means that there is a reasonable basis for dividing the premium between risks incurred in the home country and risks incurred outside the home country, but there is no direct correlation between the premium charged and the location of the risks. If a premium is apportioned between home country risks and risks incurred outside the home country, each premium payment shall be considered to be partly related to home country risks and partly related to risks incurred outside the home country. The allocation or apportionment of premiums to or between risks located in the home country and risks located outside the home country must be reasonable in relation to the location of the insured risks during the period of coverage. In considering whether a method of allocation or apportionment is reasonable, consideration shall be given to the types of risks covered and the terms of the insurance, reinsurance, or annuity contract including, but not limited to, provisions which separately describe each risk covered, the period of coverage of each risk, the special warranties for each risk, the premium for each risk, and the conditions for paying the premium for each risk. The allocation and apportionment of premiums must be consistent with the rules prescribed in paragraphs (e), (f), and (g) of this section. In addition, once a particular method has been adopted for allocating and apportioning premiums under a contract, that method must be used as long as the contract is in force.

(2) *Examples.* The following examples illustrate the rules of paragraph (d)(1) of this section:

Example 1. X is a country F controlled foreign corporation with a calendar taxable year. X insures from July 1, 1987 through June 30, 1988 a particular piece of machinery that is located in country F. The machine is moved outside country F on January 1, 1988. The contract provides for \$500 in premiums to be paid on June 30, 1987 and \$1,000 on January 1, 1988. The larger premium payment on January 1, 1988 reflects the increased risks associated with locating the machine outside country F. For the 1987 and 1988 taxable years, the period of coverage is July 1, 1987 to June 30, 1988. Because there is a direct correlation between the premium payments and the location of the risks, the premiums must be allocated. The \$500 premium payment included in X's gross income for the 1987 taxable year relates to risks incurred while the property is located in country F; therefore, all \$500 in premiums constitute SCI income. The \$1,000 included in X's gross income in the 1988 taxable year relates to coverage while the property is outside country F; therefore, all \$1,000 constitutes section 953 insurance income.

Example 2. Z is a country F controlled foreign corporation with a calendar taxable year. Z issues a policy of insurance covering risks of damage to railroad rolling stock that only travels a particular route between country F and country M. The railroad rolling stock travels an equal number of miles in both countries. A \$1,000 premium is required by Z to insure the railroad rolling stock from July 1, 1987 through June 30, 1988. The premium is paid in two installments: \$500 on June 30, 1987 and \$500 on January 1, 1988. Based on the types of risks covered by the contract of insurance and the terms of the contract, Z, in conformance with paragraph (e)(2)(i) of this section, chooses an apportionment method based on mileage. Because the premium is apportioned, \$250 of the \$500 premium included in the gross income of Z in the 1987 taxable year is attributable to home country risks and \$250 is attributable to risks outside the home country. The result for the 1988 taxable year is the same.

(3) *80 percent rule—(i) In general.* If 80 percent or more of the premium for a period of coverage of a particular contract are apportioned to risks located in the home country or to risks located outside the home country, then all of the premiums for the period of coverage are apportioned to risks incurred in or outside the home country, as the case may be.

(ii) *Example.* The following example illustrates the operation of the 80 percent rule of paragraph (d)(3)(i) of this section.

Example. Controlled foreign corporation X, which is incorporated in country F and uses the calendar year as its taxable year, issues an insurance contract insuring a machine owned by Y against damage for a one year period commencing on May 1, 1987. When the contract was issued, the machine was located in country F; however, on April 1, 1988, Y moved the machine to a branch located

outside country F. Y is required to pay premiums of \$100 per month under the terms of the insurance contract. For the taxable years ending December 31, 1987 and December 31, 1988, the period of coverage is May 1, 1987 to April 30, 1988. For that period of coverage $\frac{1}{3}$ (\$1,000/\$3,000) of the premiums are related to risks located outside country F. Because approximately 92% of the premiums are related to home country risks, all the premiums under the contract are attributable to home country risks. Therefore, the \$300 of premiums received by X from Y in the taxable year ending December 31, 1987 and the \$400 of premiums received in the taxable year ending December 31, 1988 are attributable entirely to home country risks and constitute SCI income.

(e) *Location of risks in connection with property*—(1) *In general.* Risks in connection with property covered by a contract of insurance or reinsurance are located where the property is located during the period or periods of coverage applicable to the taxable year. A risk is in connection with property if it is related to an interest of an insured in tangible (whether real or personal) or intangible property. An interest in real property includes, but is not limited to, the interest of an owner, landlord, tenant, licensee, licensor, mortgagor, mortgagee, trustee, beneficiary, or partner. Where property is located depends on all the facts and circumstances. (See paragraph (e)(2) of this section for specific rules locating certain types of property.) The determination of where property is located must be made separately under each contract of insurance or reinsurance and for each item of property covered by the contract for each period of coverage applicable to the taxable year. (However, see paragraph (e)(2)(i) of this section which permits property to be aggregated in certain circumstances for purposes of determining location of risks.)

(2) *Specific rules for locating certain types of property*—(i) *Commercial transportation property.* Premiums related to insuring or reinsuring risks in connection with any motor vehicle, ship or boat, aircraft, railroad rolling stock, or any container transported thereby ("commercial transportation property") that is used predominantly in the commercial transportation of persons or property are attributable to risks located in the home country if the property is located in the home country for the entire period of coverage, or outside the home country if the property is located outside the home country for the entire period of coverage. If the commercial transportation property is located both in and outside the home country, then the premiums shall be allocated or apportioned between risks located in

the home country and risks located outside the home country on any reasonable basis (such as time or mileage) that gives due regard to the risk being insured and that complies with the requirements of paragraphs (d)(1) and (d)(3) of this section. See paragraph (e)(3)(iii) of this section for rules relating to the location of moveable property, which includes commercial transportation property. If the location of such property cannot be determined by the end of the taxable year.

(ii) *Examples.* The following examples illustrate the operation of paragraph (e)(2)(i) of this section.

Example 1. Controlled foreign corporation Y, which is incorporated in country F, issues a property and liability insurance contract covering a helicopter that is used in rescue operations in country F as well as other countries. More than 60 percent of the miles traveled by the helicopter are outside country F. However, the helicopter is located in a hanger in country F for more than 50 percent of the period of coverage. Y apportions the premiums based on the time the helicopter is located in and outside the country of incorporation. An apportionment based on the amount of time that the helicopter is located in and outside country F is not reasonable in light of the types of risks insured and the activities in which the helicopter is engaged. Therefore, Y's apportionment of the premium will not be respected.

Example 2. Corporation Y, a country F controlled foreign corporation, insures an airplane that is used exclusively for the commercial transportation of persons or property. Of the total miles traveled by the airplane, 60 percent are traversed outside country F, and 40 percent are traversed in country F. The airplane is grounded only for repairs, and the repairs are made at the location of the airplane at the time the repairs are needed. The premiums must be apportioned on a reasonable basis between risks incurred while the plane is in country F and risks incurred while it is outside country F. On the facts presented in this example, an apportionment based on total miles traversed in and outside country F would be reasonable. Thus, 60 percent of the premiums would constitute section 853 insurance income and 40 percent of the premiums would constitute SCI income.

Example 3. The facts are the same as in Example 2 except that of the total miles traveled by the airplane, 85 percent are traversed outside the home country and 15 percent are traversed in the home country. Under the 60 percent rule of paragraph (d)(3) of this section, all of the premiums are apportioned to risks located outside country F.

(iii) *Noncommercial transportation property.* Premiums related to risks incurred in connection with any motor vehicle, ship or boat, aircraft, or railroad rolling stock not used predominantly in the commercial transportation of persons or property are attributable to

risks located outside the home country if the noncommercial transportation property is registered during the period of coverage with a country other than the home country (including any political subdivision or agency of such country) or if the owner of the property is a citizen of, resident of, or entity organized under the laws of a country other than the home country. In all other cases, noncommercial transportation property shall be deemed to be located in the home country.

(iv) *Property exported by ship or aircraft.* Premiums related to risks in connection with property exported from the home country by ship or aircraft are attributable to risks incurred while the exported property is located in the home country if the insured risks terminate when the exported property is placed aboard the ship or aircraft for export. Premiums are attributable to risks incurred while the exported property is located outside the home country if the insured risks commence when the exported property is placed aboard the ship or aircraft for export. If the insured risks commence before the exported property is placed aboard the ship or aircraft for export and terminate after the departure of the ship or aircraft from the home country, the premiums must be allocated or apportioned between risks incurred while the exported property is located in the home country and risks incurred while the property is located outside the home country on any reasonable basis (such as time or mileage) that gives due regard to the risk being insured and that complies with the requirements of paragraphs (d)(1) and (d)(3) of this section.

(v) *Property imported by ship or aircraft.* Premiums related to risks in connection with property imported into the home country by ship or aircraft are attributable to risks incurred outside the home country if the insured risks terminate when the imported property is unloaded at the home country port of entry. If the insured risks commence after the imported property is unloaded from the ship or aircraft at the home country port of entry, the premiums are attributable to risks incurred while the imported property is in the home country. If the insured risks commence before and terminate after the imported property is unloaded from the ship or aircraft at the home country port of entry, the premiums must be allocated or apportioned to or between risks incurred while the imported property is located in the home country and risks incurred while the imported property is located outside the home country on any reasonable basis (such as time or

mitage) that gives due regard to the risk being insured and that complies with the requirements of paragraphs (d)(1) and (d)(3) of this section.

(vi) *Shipments originating and terminating in the home country.* Premiums related to risks incurred in connection with property transported from one place in the home country to another place in the home country or over another country, or on or over the high seas outside the territorial waters of the home country are attributable to risks in the home country unless the premiums are allocated, in a reasonable manner, under the terms of the insurance contract to risks incurred while the property is located in the home country and risks incurred while the property is located outside the home country.

(vii) *Shipments originating and terminating in a country other than the home country.* Premiums related to risks in connection with property transported on or over the home country to and from points outside the home country are attributable to risks located outside the home country unless the premiums are allocated, in a reasonable manner, under the terms of the insurance contract to risks incurred while the property is located in the home country and risks incurred while the property is located outside the home country.

(3) *Related assets and certain moveable property—(i) Related assets.* If a contract of insurance or reinsurance covers a group of related assets, such as inventory, which are located in and outside the home country, premiums under the contract may be allocated or apportioned, on any reasonable basis, between risks located in the home country and risks located outside the home country by reference to such property taken in the aggregate.

(ii) *Example.* The following example illustrates the related assets rule of paragraph (e)(3)(i) of this section.

Example. X is a controlled foreign corporation incorporated in country F. X issues a contract of insurance to M covering M's inventory. M maintains its inventory in warehouses in country F and other countries. The risks to which the inventory is exposed are similar in each country in which the inventory is stored. For the applicable period of coverage, 40 percent of M's inventory is located in country F and 60 percent is located outside country F. The location of the property is determined on the basis of the average value of inventory warehoused in and outside of country F during the period of coverage. X may apportion 40 percent of the premiums under the contract with M to the SCI income category and 60 percent to the section 553 insurance income category.

(iii) *Moveable property.* In any case in which a contract of insurance or

reinsurance covers moveable property (other than noncommercial transportation property) and the determination of the location of the property in or outside the home country during a period of coverage cannot practicably be made by the close of the controlled foreign corporation's taxable year, the controlled foreign corporation may apportion the premiums in conformance with a reasonable expectation of where the property will be located during the period of coverage, provided that the apportionments made on all contracts to which this paragraph (e)(3)(iii) applies do not result in a material distortion. A material distortion results if the amount of premiums apportioned to the SCI or section 553 insurance income category determined by reference to the actual facts pertinent to the period of coverage, as ascertained within 90 days after the end of the period of coverage, would result in at least a 10 percentage point difference when compared to the amount of premiums apportioned to those categories under a reasonable expectation of where the property will be located during the period of coverage. In order to avail itself of this method, the controlled foreign corporation must maintain records that demonstrate the reasonableness of its apportionment, disclose the actual location of the property as ascertained within 90 days after the end of the period of coverage, and demonstrate that the apportionment did not result in a material distortion. If such records are not maintained, the apportionment method of this paragraph may not be used and the property shall be located under the rule of this paragraph (e) that would apply in absence of the method prescribed by this paragraph (e)(2)(iii). In the event of a material distortion, the United States shareholders or, if an election is made under § 1.253-7(c), the controlled foreign corporation must file amended income tax returns and apportion premiums based on the actual location of the property and the rules of paragraphs (d) and (e) of this section.

(iv) *Example.* The following example illustrates the moveable property rule of paragraph (e)(3)(iii) of this section.

Example. X is a controlled foreign corporation incorporated in country F. It uses the calendar year as its taxable year. X issues a contract of insurance covering a ship from July 1, 1988 to June 30, 1989. The contract is the only one issued by X that covers moveable property. The owner of the ship leases the ship to third persons on a per voyage basis. Based on information provided by the shipowner, 30 percent of the total miles traversed during the 12 month period immediately preceding the issuance of the

contract were in home country waters and 70 percent outside the home country. X may apportion 30 percent of the premiums received to the SCI income category and 70 percent to the section 553 insurance income category. Within 90 days after the end of the policy period, X obtains information demonstrating that the ship was used in the territorial waters of the home country 25 percent of the time and outside the territorial waters 75 percent of the time. The apportionment method used by X is reasonable and does not result in a material distortion because an apportionment based on the facts pertinent to the period of coverage would not have resulted in at least a 10 percentage point difference in the amount of premiums apportioned to the SCI or section 553 insurance income categories. Thus, X may use the apportionment method described in paragraph (e)(3)(iii) of this section provided it maintains the records required by that paragraph.

(f) *Location of risks in connection with liability arising out of activity—(1) Definition of risks in connection with liability.* A risk covered by a contract of insurance or reinsurance is in

connection with liability arising out of an activity if the insured is covered against a liability resulting from the actions of a person or a juridical entity, including actions that result in a tort, violation of contract, violation of property rights, or any other cause of action pursuant to the operation of law. The term not only includes a direct liability, which, for example, may be incurred by a tortfeasor to the person harmed, but also an indirect liability, such as the liability of one person to another resulting from the actions of an independent contractor. Moreover, a risk in connection with liability includes any loss of an insured (except a loss in connection with property described in paragraph (e) of this section) which could arise from the occurrence of an event insured against. For example, in the case of a promoter of outdoor sporting events, a risk in connection with liability arising out of an activity includes the loss that could arise from the cancellation of a sporting event because of inclement weather.

(2) *Location of risk—(i) In general.* A risk in connection with an activity is located where the activity that could give rise to a liability or loss is performed. For purposes of allocating and apportioning premiums between risks located in and outside the home country, where an activity is performed depends on the facts and circumstances of each case. Among the factors to be considered in making the determination are the location of the assets associated with the activity, the place where services comprising the activity are performed, the place where activities

intended to result in a sale occur, and the place where sales actually occur.

(ii) *Examples.* The following examples illustrate the location of risk rules of paragraph (f)(2)(i) of this section.

Example 1. X is a controlled foreign corporation that issues liability insurance and is incorporated in country M. It uses a calendar year as its taxable year. X issues a contract of insurance to Z, which owns and operates department stores in country M and other countries. The contract covers all of Z's stores. It provides coverage against "liability for bodily injury or property damage arising out of the ownership, maintenance, or use of the insured premises and all operations necessary or incidental thereto." Assuming X cannot allocate the premiums between home country and other country risks, it must apportion the premiums between those risks on a reasonable basis taking into account where the stores are located and the level of covered activities in each of those stores.

Example 2. Y is a controlled foreign corporation incorporated in country F. Y writes worker's compensation coverage. Y issues a contract to Z, which has employees in country F and other countries, covering all of Z's employees. The premiums paid by Z are not allocable to risks located in the home country and risks located outside the home country. Z must apportion the premiums on a reasonable basis taking into account where Z's employees perform services.

(3) *Specific rules locating certain activities—(i) Liability with respect to property manufactured, produced, constructed, or assembled.* Premiums under a policy of insurance or reinsurance that insures a person that manufactures, produces, constructs, or assembles property against claims arising from the consumption or use of such property are attributable to risks from an activity performed where the consumption or use of the property takes place, or if the place of consumption or use cannot be known, where the property is manufactured, produced, constructed, or assembled. If the consumption or use of the property could arise in or outside the home country, the premiums must be allocated to or apportioned between risks located in the home country and risks located outside the home country on any reasonable basis that gives due regard to the risk being insured and that complies with the requirements of paragraphs (d)(1) and (d)(3) of this section.

(ii) *Examples.* The following examples illustrate the rule of paragraph (f)(3)(i) of this section.

Example 1. X is a contractor that constructs apartment buildings. X uses a system of pre-fabricated construction that entails constructing parts of the apartment buildings in country F and assembling them outside of country F. The only completed apartment buildings constructed by X are

outside of country F. X is insured by Z, a country F controlled foreign corporation, against liability for the improper construction of, or the failure to construct, an apartment building. Z is insuring risks in connection with an activity that arises outside of country F because that is where the use of the property takes place.

Example 2. M manufactures automobiles in facilities located in country W. M is covered by a single policy of insurance issued by F, a controlled foreign corporation organized in country W. M sells its automobiles through independent dealers all over the world including country W. F charges a single premium to insure M against any liability for harm to persons or damage to property arising from a manufacturing defect. F must apportion the premium between risks located in W and risks located outside W on a reasonable basis because the use of the automobiles occurs in and outside of country W. However, if it cannot be known where the automobiles are used, then F is deemed to be insuring risks in connection with an activity that arises in country W because that is where the automobiles are manufactured.

(iii) *Location of activities in connection with transportation property.* Premiums under a contract of insurance or reinsurance covering risks in connection with the operation of a motor vehicle, ship or boat, aircraft, or railroad rolling stock are attributable to risks in connection with an activity performed where the transportation property is located under the principles of paragraph (e)(2) (i) and (iii) of this section relating to the location of transportation property.

(iv) *Example.* The following example illustrates the rule of paragraph (f)(3)(iii) of this section.

Example. X is a controlled foreign corporation created under the laws of country F and uses the calendar year as its taxable year. X insures B, a pilot for a commercial airline, against any damage to persons or property arising from B's professional activities. X charges a \$70,000 premium, payable \$2,000 at the inception of the policy and \$5,000 on January 1, 1988, for a one year policy providing coverage from July 1, 1987 to June 30, 1988. B always pilots the same round trip flight from country F to country R and back. For both the 1987 and 1988 taxable years, the period of coverage is July 1, 1987 to June 30, 1988. On each trip from F to R the aircraft traverses half of the total mileage in country F and half in country R. Because the aircraft B flies is located in the home country one-half of the time, a reasonable basis exists for apportioning one-half of the premiums paid by B to risks arising from his activities outside the home country and one-half to activities arising in the home country. Thus, for the 1987 taxable year, the \$5,000 of premiums are apportioned so that \$2,500 of the premiums are attributable to home country risks and \$2,500 of the premiums are attributable to risks located outside the home country. For the 1988 taxable year, the results are the same.

(v) *Selling activity.* The liability of a person arises from selling activity only if, and to the extent that, the liability does not relate to liability in connection with property manufactured, produced, constructed, or assembled, as described in paragraph (f)(3)(i) of this section, or liability for activities in connection with transportation property, as described in paragraph (f)(3)(iii) of this section. A person is engaged in selling activity if the person engages in any activity which is intended to result in the sale of property. Premiums received on a contract of insurance or reinsurance covering risks in connection with selling activity are attributable to risks incurred where the selling activity takes place regardless of whether the property passes through, or is delivered in, the country in which the selling activity is carried on. Selling activity takes place where the activities preparatory to the sale, such as advertising, negotiating, and distributing, take place.

(vi) *Example.* The following example illustrates the rule of paragraph (f)(3)(v) of this section.

Example. Corporation M, a country W corporation, insures a wholesale distributor against liability arising out of a breach of warranty. The wholesale distributor negotiates and processes orders in country W, but sells its inventory exclusively in countries other than country W by advertising in trade publications and distributing sales catalogues in those countries. The premiums on the policy issued to M are attributable to risks arising from activities performed both in and outside country W and M must allocate and apportion, on a reasonable basis, the premiums received for insuring the wholesale distributor between risks located in country W and risks located outside country W.

(g) *Location of risks in connection with life or health—(1) In general.* Risks in connection with life or health include risks under contracts of insurance, reinsurance, annuity contracts, or cancellable health and accident contracts defined in section 803(a) (relating to the definition of a life insurance company). Risks under cancellable health and accident contracts are also risks in connection with life or health. An annuity contract under which annuity payments are not determined by reference to life contingencies, is treated, for purposes of section 953 as a contract covering risks in connection with life or health. The risk under any insurance, reinsurance, or annuity contract covered by this paragraph (g)(1) is located in the country where the person with respect to whom the risk is located (the "determining life") is resident. The determining life with respect to any life, accident, or

health insurance or reinsurance contract is the person whose life or health is covered by the contract. The determining life with respect to a life annuity contract is the person by whose life the annuity payments are measured. The determining life with respect to an annuity certain is the life of the person who purchases the annuity contract and the life of the person for whose benefit the annuity was purchased. Thus, risks in connection with an annuity certain are deemed to be located in their entirety outside a controlled foreign corporation's home country if either the purchaser of the contract or the recipient of the annuity payments resides outside the home country, as determined in accordance with the rules of this paragraph. The person with the determining life is presumed to be resident at the last address given to the controlled foreign corporation as such person's residence, unless the controlled foreign corporation knows or has reason to know that such person is resident at a different address. Premiums received under a contract of group life or health insurance must be apportioned between risks located in the home country and risks outside the home country on the basis of the last known addresses of the residences of the persons insured under the contract or, in the case where the contract is issued to an employer where the persons covered by the contract are employed.

(2) *Example.* The following example illustrates the rules of paragraph (g)(1) of this section.

Example. Controlled foreign corporation X, a country F corporation and a calendar year taxpayer, is engaged in the life insurance business. On July 1, 1987, X issues a three year term life insurance contract on the life of B. Premiums under the contract are payable on July 1 and December 31 of each year the contract is in force. B gives to X an address in country F as the address of his primary residence. On November 1, 1987, B changes his primary residence from country F to country Z. B notifies X of the change of address on February 1, 1988. For X's 1987 taxable year the premiums received on July 1, 1987 and December 31, 1987 are allocable to the SCI income category. Because X did not have knowledge, and had no reason to know, of B's change of address until February 1, 1988, it may rely, for all premium payments received before February 1, 1988, on the address B initially provided at the time the contract was approved. However, all premiums received after February 1, 1988 constitute section 953 insurance income because X had knowledge at the time those premiums were received that B had his or her primary residence outside of country F.

(h) *Risks deemed to be located in a country other than the home country—*
(1) *Artificial arrangements.* The section

953 insurance income of a controlled foreign corporation includes any insurance income from issuing or reinsuring insurance policies or annuity contracts covering risks located in the home country if the insurance, reinsurance, or annuity contracts are attributable to any direct or indirect cross-insurance arrangement whereby the controlled foreign corporation provides insurance, reinsurance, or annuity contracts relating to home country risks and, in exchange, another person provides insurance, reinsurance, or annuity contracts relating to risks located outside the home country. Arrangements to which this rule applies include those entered into by the controlled foreign corporation, persons related (within the meaning of section 954(d)(3)) to the controlled foreign corporation, the United States shareholders of the controlled foreign corporation, and persons related to such shareholders.

(2) *Evidence of arrangements.* The determination of whether an arrangement referred to in paragraph (h)(1) of this section exists depends on all the facts and circumstances. Facts to be considered in determining the existence of such an arrangement include the premiums charged in relation to the risks insured, the profit margin expected from the contracts, and the loss experience of the risks which the other person insures or reinsures compared with the loss experience of the risks which the controlled foreign corporation insures or reinsures. Further, consideration will be given to the existence of common directors or owners between the parties executing the reciprocal insurance arrangement. The period in which the controlled foreign corporation receives premiums and the period of coverage for which the premiums are received need not be the same as, or identical in length with, that of the other person or limited to a single taxable year of the controlled foreign corporation.

(3) *Examples.* The following examples illustrate the principles of paragraph (h) of this section.

Example 1. Controlled foreign corporation X is incorporated in country F and is a wholly-owned subsidiary of corporation M, a United States corporation. Foreign corporation Y is a wholly owned subsidiary of foreign corporation R. R is not a controlled foreign corporation. Corporations M and R, which are not related, agree that from July 1, 1987 through December 31, 1987, Y corporation will reinsure certain policies issued by M covering risks that are located outside country F, and that from January 1, 1988 through June 30, 1988, X will reinsure certain policies issued by R covering risks that are located in country F. The premiums

received by X corporation from reinsuring the risks of R are attributable to risks located outside country F and constitute section 953 insurance income.

Example 2. The facts are the same as in *Example 1* except that one-third of the risks of M to be reinsured are reinsured with Y and two-thirds of the risks are reinsured with Z, another wholly owned foreign subsidiary of R. The premiums received by X from reinsuring the policies of R are attributable to risks located outside country F and constitute section 953 insurance income.

Example 3. The facts are the same as in *Example 1* except that X and V, another wholly-owned foreign subsidiary of M, reinsure the risks of R. The premiums received by X and V from reinsuring the policies of R are attributable to risks located outside country F and constitute section 953 insurance income.

§ 1.953-3 Allocation of premiums to the RPII or nonRPII categories of section 953 insurance income.

(a) *In general.* All premiums that constitute section 953 insurance income are included within one of two categories: premiums that constitute related person insurance income ("RPII premiums") under paragraph (b) of this section and premiums that do not constitute RPII premiums ("nonRPII premiums"). RPII premiums are not recharacterized premiums even though the exceptions of § 1.953-7 are applicable. However, if the exceptions of § 1.953-7 (a) or (b) apply, persons that are United States shareholders solely by virtue of section 953(c)(1)(A) and paragraph (b)(2) of this section of a controlled foreign corporation, as defined in section 953(c)(1)(B) and paragraph (b)(2) of this section, do not include RPII income in their gross income. Persons that are United States shareholders within the meaning of section 951(b) of a controlled foreign corporation as defined in section 957 must always include RPII income in their gross income, regardless of whether the exceptions of § 1.953-7 (a) or (b) apply. However, the special pro rata share rules of section 953(v)(5) and § 1.953-6 (h)(1) shall not apply if the conditions of section 953(c)(1)(A) and (B) and § 1.953-7 (a) and (b) are met.

(b) *Related person insurance income—*(1) *In general.* Related person insurance income is included, within the meaning of the term "insurance income" as that term is used in section 953. Related person insurance income is premium and investment income attributable to a policy of insurance or reinsurance that provides insurance coverage to a related insured on risks located outside the controlled foreign corporation's country of incorporation or premium and investment income

attributable to an annuity contract that is purchased by or for the benefit of a related insured if the determining life is located outside the controlled foreign corporation's country of incorporation. For this purpose, a related insured is any insured, purchaser of an annuity contract, or recipient of annuity payments that is a United States shareholder of the controlled foreign corporation or a related person (within the meaning of section 954(d)(3)) to a United States shareholder.

(2) *Definitions*—(i) *United States shareholder, related person, and controlled foreign corporation.* For purposes of determining whether insurance income is related person insurance income, the terms "United States shareholder," "related person to a United States shareholder," and "controlled foreign corporation" are specifically defined. The term "controlled foreign corporation" means any foreign corporation if 25 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote or 25 percent or more of the total value of the stock of the foreign corporation is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of the foreign corporation. For purposes of applying this section to a foreign mutual insurance company, the term stock includes any certificate entitling the holder to voting power in the mutual company. See section 958(a)(3). A "United States shareholder" for these purposes is any United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)) any stock of the foreign corporation at any time during the foreign corporation's taxable year. A person is a related person to a United States shareholder if the person is related within the meaning of section 954(d)(3) of the Code to the United States shareholder. Thus, a person is related to a United States shareholder if the person controls (within the meaning of section 954(d)(3)), or is controlled by, the United States shareholder, or the person is controlled by the same person (or persons) that controls the United States shareholder. In addition, in the case of any policy of insurance covering liability arising from services performed as a director, officer, or employee of a corporation, or as a partner or employee of a partnership, the person performing such services and the entity for which such services are performed shall be treated as related persons.

(ii) *Examples.* The following examples illustrate the definitions of paragraph (b)(2)(i) of this section.

Example 1. X is a country F corporation that provides insurance coverage to its 100 shareholders. X has voting common stock and nonvoting preferred stock issued and outstanding. All of the voting common stock is owned by 75 foreign persons. None of the foreign shareholders are related persons within the meaning of section 954(d)(3). All of the nonvoting preferred stock is owned by 25 United States persons. The nonvoting preferred stock accounts for 25 percent of the total value of both classes of stock outstanding. Therefore, each United States person is a United States shareholder and X is a controlled foreign corporation under section 953(c)(2)(B). The premiums from policies of insurance issued to the twenty-five United States shareholders constitute RPI premiums to the extent those premiums relate to risks located outside country F. The premiums from the 75 foreign shareholders constitute nonRPI premiums to the extent those premiums relate to risks located outside country F.

Example 2. The facts are the same as in *Example 1* except that all of the nonvoting preferred stock is owned by a foreign corporation, all of the stock of which is owned by the 25 United States persons. Under section 954(a)(2), the United States persons are considered as owning the stock owned by the foreign corporation. Therefore, X is a controlled foreign corporation and the 25 United States persons are United States shareholders.

Example 3. The facts are the same as in *Example 1* except that 6 of the nonvoting preferred stock shareholders are insured by X and 20 are not. X is a controlled foreign corporation and all 25 United States persons are United States shareholders. A United States person need not be insured by the controlled foreign corporation to be a United States shareholder of that corporation.

Example 4. Y is a foreign corporation that issues policies of insurance and reinsurance. The one class of Y stock outstanding is owned equally by 25 shareholders who are United States persons. None of the shareholders of Y are insured by Y; however, five of the policies issued by Y are issued to wholly-owned foreign subsidiaries of five of Y's shareholders. The premiums attributable to the policies of insurance issued with respect to the foreign subsidiaries constitute RPI premiums. The insured foreign subsidiaries are related persons to United States shareholders because those subsidiaries are controlled (within the meaning of section 954(d)(3)) by United States shareholders.

(iii) *United States shareholder: exception for indirect ownership: publicly traded stock.* A United States person who is not insured or reinsured (directly or indirectly) by a foreign corporation (the "insuring foreign corporation") and is not related to a person insured (directly or indirectly) by the insuring foreign corporation shall not be treated as a United States

shareholder of the insuring foreign corporation by virtue of section 958(a)(2) because of such person's ownership of stock in another foreign corporation which owns stock (directly or indirectly) in the insuring foreign corporation if:

(A) The stock of the other foreign corporation is publicly traded;

(B) The United States person owns less than five percent of the combined voting power of all classes of stock entitled to vote and less than five percent of the total value of the stock of the other foreign corporation; and

(C) The stock of the insuring foreign corporation constitutes less than five percent of the gross value of all the assets of the other foreign corporation.

(iv) *Example.* The following example illustrates the indirect ownership exception of paragraph (b)(2)(iii) of this section.

Example. X is a foreign corporation which writes policies of insurance for its shareholders and unrelated persons. X has one class of stock outstanding. Five shareholders of X, who are United States persons, each own 4 percent of X's stock. These shareholders are also insured by X. The remaining 80 percent of the X stock is owned by corporation Y, a foreign corporation the stock of which is publicly traded. X insures certain risks of Y. All of the stock of Y is owned by United States persons, but no shareholder of Y owns more than 5 percent of the stock of Y by vote or value or is insured by X. None of the United States persons are related to Y or to each other. The X stock owned by Y constitutes less than five percent of the total value of all of Y's assets. The United States persons who own the stock of Y are not considered United States shareholders of X under section 958(a)(2) because the requirements of paragraph (b)(2)(iii) of this section are met. Therefore, only 20 percent of the X stock is owned by United States persons and X is not a controlled foreign corporation.

(v) *Controlled foreign corporation: shipowner's protection and indemnity association.* A controlled foreign corporation meeting the definition of paragraph (b)(2)(i) of this section and also qualifying as a shipowner's protection and indemnity association under section 526 of the Code is a controlled foreign corporation subject to the provisions of §§ 1.953-1 through 1.953-7. Thus, a United States shareholder of such an association must include its pro rata share of the receipts of such an association that constitute section 953 insurance income, including premiums, dues, and assessments, less appropriately allocated and apportioned expenses, losses and other deductions. In such shareholder's gross income as required by § 1.953-6(b) notwithstanding section 526. See § 1.952-2(c)(1) which states that subchapter F does not apply

in determining the gross income of a controlled foreign corporation.

(3) *Reinsurance*—(i) *In general.* Related person insurance income includes income attributable to contracts of reinsurance, including reinsurance arrangements in which the reinsurer accepts all the rights and obligations under the reinsured contracts, pursuant to which the controlled foreign corporation reinsures contracts issued by its United States shareholders, or related persons to such shareholders.

(ii) *Examples.* The following examples illustrate the rule of paragraph (b)(3)(i) of this section.

Example 1. Twenty-five domestic corporations, which are engaged in the business of issuing property insurance policies to unrelated commercial entities, formed Z under the laws of country W to reinsure a portion of the risks insured by the domestic corporations. Each of the twenty-five domestic corporations owns an equal amount of the one class of stock of Z outstanding. Z has no business other than reinsuring the policies issued by its shareholders. The premiums received by Z constitute RPI premiums.

Example 2. The facts are the same as in *Example 1.* However, X, one of the shareholders of Z, enters a portfolio (assumption) reinsurance agreement with Z under which Z assumes all of the rights and obligations under certain policies issued by X. Z notifies the policyholders that it is assuming all the rights and obligations under the policies issued by X. The premiums from the reinsured policies constitute related person insurance income even though X no longer has any rights or obligations under the policies.

(4) *Indirectly insuring a related insured: Fronting*—(i) *In general.* For taxable years beginning after December 31, 1987, premiums received on insurance contracts, or contracts reinsuring insurance contracts, that indirectly insure United States shareholders of a controlled foreign corporation or persons related to such shareholders are included within the definition of related person insurance income. A contract indirectly insures a United States shareholder or person related to such shareholder if the contract is issued by an unrelated person and the contract is ultimately reinsured with the controlled foreign corporation in which the United States shareholder owns stock. For taxable years beginning after December 31, 1987, premiums received on annuity contracts, or contracts reinsuring annuity contracts, that are indirectly purchased by, or indirectly provide annuity benefits to, a United States shareholder or persons related to such shareholders are included within the definition of related person insurance income.

(ii) *Example.* The following example illustrates the rule of paragraph (b)(4)(i) of this section.

Example. Z is a domestic corporation that has issued a policy of insurance to Y. Y is a domestic corporation which owns stock in X, a controlled foreign corporation within the meaning of section 1.653-3(b)(2)(i). Z does not own any of the stock of X. Z reinsures with X part of the risk it insures under the policy issued to Y. The premiums received by X for reinsuring the policy issued to Y are RPI premiums because one of its United States shareholders, Y, is indirectly an insured of X.

(5) *Cross-insurance arrangements*—(i) *In general.* Related person insurance income includes insurance income attributable to a direct or indirect cross-insurance arrangement whereby the controlled foreign corporation issues an insurance, reinsurance, or annuity contract to a person other than a related insured (as defined in paragraph (b)(1) of this section) in return for another person issuing an insurance, reinsurance, or annuity contract to a person that would be a related insured if the controlled foreign corporation were to issue an insurance, reinsurance, or annuity contract to such person. See § 1.653-2(b).

(ii) *Example.* The following example illustrates the rule of paragraph (b)(5)(i) of this section.

Example. Controlled foreign corporation X is owned by 30 United States shareholders engaged in a similar line of business. Controlled foreign corporation Y is owned by 32 United States shareholders engaged in the same line of business as the 30 shareholders of X. Both X and Y provide insurance to businesses engaged in the line of business in which their shareholders are engaged as well as other types of business. X agrees to provide insurance protection to Y's shareholders and Y agrees to provide insurance to X's shareholders. The premiums of both X and Y that relate to insuring the shareholders of the other corporation constitute related person insurance income.

(6) *Specific premium rules*—(i) *Premiums received prior to January 1, 1987.* Related person insurance income includes premiums written (less return premiums and premiums paid for reinsurance) before the first taxable year of the controlled foreign corporation beginning after December 31, 1986 that become earned under section 832(b)(4) in a taxable year beginning after December 31, 1986, or succeeding taxable years, provided that the premiums otherwise qualify as related person insurance income.

(ii) *Apportionment of premiums if stock owned for less than entire taxable year.* If, during a taxable year of a controlled foreign corporation, an insurance, reinsurance, or annuity

contract that relates to a United States shareholder remains in force beyond the period during which the United States shareholder owns stock in the controlled foreign corporation, the amount of the premiums, as defined in § 1.653-2(c), attributable to the contract must be apportioned between the RPI category and the nonRPI category. The amount apportioned to the RPI category is equal to the amount of premiums on the contract included in the gross income of the controlled foreign corporation in the taxable year multiplied by a fraction, the numerator of which is the number of days in the period of coverage which fall within the taxable year during which the United States shareholder owned stock in the controlled foreign corporation, and the denominator of which is the total number of days in the period of coverage that fall within the taxable year. The remainder of the premiums on the contract are apportioned to the nonRPI category.

(iii) *Examples.* The following examples illustrate the rule of paragraph (b)(6)(ii) of this section.

Example 1. Y is a country F controlled foreign corporation with a calendar taxable year. Y issues a policy of insurance to M, one of its United States shareholders, covering risks of property damage to a plant owned by M. The plant is located outside country F. The policy covers risks incurred from July 1, 1987 to June 30, 1988. M pays premiums of \$1,000 on July 1, 1987 and \$1,000 on January 1, 1988. On September 30, 1987, M sells all of its stock in Y. In Y's 1987 taxable year, there are 183 days during which M is insured. M is a stockholder in Y for 92 days during the 1987 taxable year. Therefore, of the \$1,000 of premiums from M included in Y's gross income in its 1987 taxable year, \$503 (\$1,000 x 92/183) is allocated to the RPI premium category and \$497 is allocated to the nonRPI premium category. For the 1988 taxable year, all \$1,000 of premiums from M are allocated to the nonRPI premium category because M owns no stock in Y on any day of the period of coverage falling within the 1988 taxable year.

Example 2. The facts are the same as in *Example 1* except that M sells only a part of its Y stock on September 30, 1987. Because M remains a shareholder in Y, all the premiums received from M in the 1987 and 1988 taxable years are allocated to the RPI premium category.

(iv) *Anti-abuse rule.* If the facts and circumstances indicate that the premiums charged on an insurance, reinsurance, or annuity contract that gives rise to related person insurance income are below the premium rate charged on comparable contracts issued to unrelated persons, then the district director can recast capital contributions or other amounts paid or deposited by the United States shareholder as

premiums on an insurance, reinsurance, or annuity contract. See also section 402 (allocation of income and deductions among taxpayers) and section 845 (certain reinsurance agreements).

(v) *Example.* The following example illustrates the anti-abuse rule of paragraph (b)(5)(iv) of this section.

Example. X is a controlled foreign corporation incorporated in country P that insures the risks of its shareholders, all of whom are United States persons, as well as the risks of unrelated persons. In 1987, X issued fire insurance policies to some of its shareholders and to unrelated persons covering property located outside country F. The premium rates charged to the shareholders under the policies were less than those charged to similarly situated unrelated persons. The shareholders who are insured under the fire insurance policies also purchased preferred stock on which X has call rights which become effective on the same dates that the policies expire. The facts indicate that the amounts paid for the preferred stock are actually part of the cost of the insurance provided to the shareholders. All or part of the amounts paid for the preferred stock may be recharacterized as premiums paid on insurance policies.

§ 1.953-4 Allocation and apportionment of items of investment income.

(a) *In general.*—(1) *Investment income.*

This section prescribes the rules for determining the amount of investment income within the RPII, nonRPII, and SCI categories. Except as provided in paragraph (a)(2) of this section, investment income for this purpose is any type of income of a controlled-

foreign corporation for the taxable year other than premiums as defined in § 1.953-2(c). Thus, investment income includes, but is not limited to, gain from the sale or disposition of property under section 832(b)(1)(B), interest, dividends, and rents. Investment income also includes, to the extent prescribed in paragraph (a)(2) of this section, income resulting from the decrease in section 807(c) items under section 807(a), income resulting from the decrease in section 807(c)(1) items included in unearned premiums of a property and casualty insurance company under section 832(b)(4), and income resulting from a reduction of discounted unpaid losses under section 832(b)(5). An item of investment income is allocated to a particular category, whether the RPII, nonRPII, or SCI category, only if the income results from a decrease in reserves attributable under the principles of § 1.953-5(a) to a particular category or if the requirements of paragraph (b) of this section are met. If an item of investment income cannot be allocated to the RPII, nonRPII, or SCI categories, it is apportioned to the different categories in accordance with

paragraph (c) of this section. If the investment income within each of the RPII, nonRPII, and SCI categories is determined under the apportionment method of paragraph (c) of this section, then the investment income within each category shall be deemed to consist of each type of investment income (e.g., dividends, interest, tax-exempt interest, and capital gains) in the same proportion that the aggregate amount of a particular type of investment income earned during the taxable year bears to the total amount of all types of investment income earned during the taxable year.

(2) *Decreases in reserves.*—(i) *In general.* In the case of each of the RPII, nonRPII, and SCI categories of income, if a decrease in section 807(c) items or a decrease in section 846 discounted unpaid losses occurs as the result of the payment of claims and benefits accrued and losses incurred, as described in section 905(a)(1), or as the result of losses paid, as described in section 832(b)(5)(A)(i), then the income resulting from the decrease in reserves shall be deemed to consist of premium and investment income in the same proportion that the claims, benefits, or losses that result in the decrease in the reserve are apportioned between premium and investment income under § 1.953-6(c)(3)(iii)(A). Section 807(c) items include section 807(c)(1) reserves included in the unearned premiums of a property and casualty insurance company under section 832(b)(4). If a decrease in section 807(c) items and section 846 unpaid losses attributable under the principles of § 1.953-5(a) to the SCI category and to the RPII category (if the elections under section 953(c)(3)(C) and section 831(b) are made) occurs as the result of any actuarial redetermination, the amount of income included in gross income in accordance with section 807(f), in the case of a foreign life insurance company, or in accordance with section 481, in the case of a foreign property and casualty insurance company, shall be considered investment income equal to the amount obtained by multiplying the decrease in section 807(c) items or section 846 discounted unpaid losses by a fraction. The numerator of the fraction shall be the amount of the increase in section 807(c) items or section 846 discounted unpaid losses that have been apportioned against investment income under § 1.953-5(c)(3)(iii)(B) and (C) during the five taxable years (or the period during which the controlled foreign corporation has been in existence, if less than five taxable years) preceding the current taxable year. The denominator of the fraction

shall be the total amount of deductions attributable to the increases in section 807(c) items and section 846 discounted unpaid losses during the five taxable years (or shorter period, if applicable) preceding the current taxable year. The remainder of the decrease in section 807(c) items and section 846 discounted unpaid losses attributable to the SCI category and, if appropriate, the RPII category shall be treated as giving rise to premium income. In the case of section 807(c) items and section 846 discounted unpaid losses attributable to the nonRPII category and the RPII category, if the section 953(c)(3)(C) and section 831(b) elections have not been made, the entire decrease in section 807(c) items and section 846 discounted unpaid losses shall be treated as investment income.

(ii) *Examples.* The following examples illustrate the principles of paragraph (a)(2)(i) of this section.

Example 1. Y is a life insurance company and is a controlled foreign corporation. In 1988 Y's section 807(c)(1) life insurance reserves decrease from \$10,000 to \$8,000, resulting in \$2,000 of income under sections 905(a)(2) and 807(a). The decrease resulted from the payment of a death benefit that under § 1.953-6(c)(3)(iii)(A), is apportioned against investment income and premium income in the amount of \$1,500 and \$500, respectively. The \$2,000 decrease results in \$1,500 of investment income ($\$2,000 \times \$1,500 / \$2,000$) and \$500 of premium income ($\$2,000 \times \$500 / \$2,000$).

Example 2. X is a property and casualty insurance company and is a controlled foreign corporation. Under section 832(b)(5), X had, for its 1987 taxable year, discounted unpaid losses of \$100,000 attributable to contracts the premiums from which were allocable to the SCI category of income. For 1988, X had losses paid of \$50,000 and discounted unpaid losses of \$25,000 allocable to contracts giving rise to SCI premiums. Section 832(b)(5) requires X to reduce its 1987 losses paid by the excess of discounted unpaid losses for 1987 over the current year discounted unpaid losses. Thus, X has \$25,000 of income resulting from the decrease in discounted unpaid losses computed as follows: 1988 losses paid of \$50,000 minus the difference between 1987 discounted unpaid losses of \$100,000 and 1988 discounted unpaid losses of \$25,000 [$\$50,000 - (\$100,000 - \$25,000) = \$25,000$]. Assuming that section 481 applies, X will take the premium and investment income into account in accordance with that section. If over the past five years, the increase in discounted unpaid losses is \$50,000, of which \$10,000 was allocated to investment income and \$40,000 to premium income under § 1.953-6(c)(3)(iii)(B) and (C), then 1/5th ($\$10,000 / \$50,000$) of the amounts taken into income in each taxable year in accordance with section 481 will be treated as investment income and 4/5ths ($\$40,000 / \$50,000$) will be treated as premium income.

(b) Allocation of investment income—

(1) *In general.* An item of investment income is allocated to a particular category of income if the item directly relates to a contract (or that part of a contract) which gives rise to premiums allocable to the same category of income. An item of investment income is considered to be directly related to a contract (or that part of a contract) which gives rise to premiums allocable to a particular category if the income is derived from an asset which is identified on the controlled foreign corporation's books and records as an asset relating to RPII, nonRPII, or SCI contracts and the controlled foreign corporation separately accounts for the various income, exclusion, deduction, reserve, and other liability items properly attributable to such contracts.

(2) *Examples.* The following examples illustrate the rules of paragraph (b)(1) of this section.

Example 1. The facts are the same as in Example 2 of paragraph (a)(2)(iii) of this section. The amount of investment income included in gross income in each taxable year in accordance with section 401 is allocable to the SCI category.

Example 2. Z is a country F controlled foreign corporation which issues life insurance contracts. Among the contracts issued by Z are variable life insurance contracts issued to residents of country F. The life insurance contracts qualify as variable contracts under section 817(d) of the Code. The amounts received under the contracts are allocated pursuant to country F law to an account which is segregated from the general asset accounts of Z, and the amount of the death benefits under the contracts are adjusted on the basis of the investment return and the market value of the segregated asset account. Z's books of account identify the assets relating to the variable life insurance contracts issued to residents of country F, and Z separately accounts for the various income, exclusion, deduction, reserve, and other liability items properly attributable to such contracts. Therefore, all of the investment income attributable to the variable contracts is allocable to the SCI income category.

(c) Apportionment of investment income—

(1) *Life insurance companies—*
 (i) *In general.* A foreign corporation that would determine its insurance income under part I of subchapter L (relating to life insurance companies) if it were a domestic company shall apportion its investment income to each of the RPII, nonRPII, and SCI categories, in the same proportion that—

(A) The sum of the means of each of the items described in section 807(c) attributable to contracts which give rise to premiums within the particular income category bears to

(B) The sum of the means of the items described in section 807(c) for the

taxable year attributable to all contracts.

(ii) *Section 807(c) items attributable to RPII, nonRPII, and SCI contracts.* The amount of an item described in section 807(c) that is attributable to a particular income category is that amount which would result if the section 807(c) item were computed, using the assumptions required under section 807, as modified by § 1.853-6(e), only with respect to the contracts the premiums from which are apportioned to that particular income category.

(2) *Property and casualty companies—*
 (i) *In general.* A foreign corporation that would determine its insurance income under part II of subchapter L (relating to insurance companies other than life insurance companies) if it were a domestic company shall apportion its investment income to each of the RPII, nonRPII, and SCI categories, in the same proportion that—

(A) The sum of the premiums written, as defined in section 832(b)(4)(A), for the current taxable year, plus the amount of unearned premiums as of the close of the previous taxable year, plus the amount of the section 848 discounted unpaid losses as of the close of the previous taxable year attributable to the particular income category, bears to

(B) The sum of the premiums written as defined in section 832(b)(4)(A), for the current taxable year, plus the amount of unearned premiums as of the close of the previous taxable year, plus the amount of the section 848 discounted unpaid losses as of the close of the previous taxable year attributable to all categories of income.

(ii) *Unpaid losses attributable to a particular category.* The amount of the section 848 discounted unpaid losses that are attributable to a particular income category is that amount which would result if the unpaid losses were computed, using the assumptions required by section 848, as modified by § 1.853-6(e), only with respect to the contracts the premiums from which are apportioned to that particular income category.

(3) *Examples.* The following examples illustrate the principles of paragraph (c) of this section.

Example 1. X is a property and casualty insurance company and a controlled foreign corporation that is not engaged in a trade or business in the United States. X is a calendar year taxpayer. In 1987, X had \$800 of premiums written from contracts issued to related insureds and \$300 of premiums written from contracts issued to unrelated persons. At the end of 1988, X had \$400 in unearned premiums from contracts issued to related insureds and \$200 of unearned

premiums from contracts issued to unrelated persons. X also had unpaid losses at the end of 1988 of \$500 with respect to its related insured contracts and \$250 with respect to its contracts issued to unrelated persons. In 1987, X had \$1,000 of taxable interest income and \$2,000 of tax exempt income. The total of X's premiums written for the current year, plus previous year unearned premiums, plus previous year unpaid loss reserves on RPII business is \$1,500 (\$800 + \$400 + \$300) and on nonRPII business is \$750 (\$300 + \$200 + \$250). Therefore, \$2,000 of investment income (\$1,500/\$2,250 x \$3,000) is apportioned to the RPII category and \$1,000 (\$750/\$2,250 x \$3,000) is apportioned to the nonRPII category. Pursuant to paragraph (a)(1) of this section, of the \$2,000 apportioned to the RPII category, \$666.67 (\$2,000 x \$1,000/\$3,000) is taxable interest income and \$1,333.33 (\$2,000 x \$2,000/\$3,000) is tax-exempt interest. Of the \$1,000 apportioned to the nonRPII category, \$333.33 (\$1,000 x \$1,000/\$3,000) is taxable interest income and \$666.67 (\$1,000 x \$2,000/\$3,000) is tax-exempt interest income.

Example 2. (i) Y is a controlled foreign corporation that issues life insurance policies and would, if it were a domestic corporation, be taxable under part I of subchapter L of the Code. Y is not engaged in a trade or business within the United States. In 1987, its first year in business, Y only issues insurance policies to its United States shareholders or persons related to its United States shareholders. Y received \$3,000 in premiums for the year and at the end of the year had a reserve under section 807(c)(1) of \$2,000. In 1988, Y only issues life insurance policies to persons other than its United States shareholders or persons related to those shareholders. Y receives \$5,000 in premiums in 1988. Y's year-end section 807(c)(1) reserves with respect to contracts issued to related persons is \$1,000 and with respect to unrelated persons is \$4,000. Investment income in 1988 is \$1,000, all of which is taxable interest income. The means of the 807(c) items for 1988 are computed in Table 1 below.

TABLE 1.—MEAN SECTION 807(C) ITEMS ATTRIBUTABLE TO RPII CONTRACTS IN FORCE IN 1988

Mean of life insurance reserves attributable to RPII policies:	
1987 closing reserve	\$2,000
1988 closing reserve	\$1,000
Mean = (\$2,000 + \$1,000)/2	\$1,500
Mean of life insurance reserves attributable to non-RPII policies:	
1987 closing reserve	10
1988 closing reserve	\$4,000
Mean = (\$4,000 + 10)/2	\$2,005

(ii) Based on the computations in Table 1, the investment income apportioned to the RPII category equals \$1,000 x (\$1,500/\$2,005) or \$728.57, and investment income apportioned to the nonRPII category equals \$1,000 x (\$2,000/\$2,005) or \$271.43.

§ 1.953-5 Allocation and apportionment of expenses.

(a) *Allocation of deductions to RPII, nonRPII, and SCI categories.* To compute the amount of section 953 insurance income or foreign personal holding company income that a controlled foreign corporation has derived from insurance operations, items of expenses, losses, and other deductions (collectively referred to as "deductions") must be allocated to and apportioned among the RPII, nonRPII, and SCI categories of income. Allocation of expenses shall be made in accordance with §§ 1.861-8, 1.861-9T, 1.861-9T, 1.861-10T, and 1.861-12T, and this section. The deduction under section 832(b)(4)(B) for unearned premiums is allocable to the categories to which the unearned premiums relate as determined by §§ 1.953-2 and 1.953-3. The deductions for death benefits, increases in reserves, policyholder dividends, consideration in respect of the assumption by another person of liabilities, and reimbursable dividends under section 803(a)(1), (2) (3), (6), and (7) are allocable to the particular category of income to which those deductions relate. The deductions for losses paid and discounted unpaid losses, under section 832(b)(5), and dividends and similar distributions paid or declared to policyholders in their capacity as such, under section 832(c)(11), are also allocable to the particular category of income to which those deductions relate. The amount of the deductions specified in the preceding two sentences of this paragraph shall be considered to relate to the RPII, nonRPII, and SCI categories to the extent the deduction is attributable to contracts that give rise to premiums allocated to a particular category. Deductions not specifically addressed in this paragraph (a) may be allocated to the RPII, nonRPII, or SCI category of income if the controlled foreign corporation identifies on its books and records the assets which relate to RPII, nonRPII, or SCI contracts, and the controlled foreign corporation separately accounts for the various income, exclusion, deduction, reserve, and other liability items properly attributable to such contracts.

(b) *Apportionment of expenses to RPII, nonRPII, and SCI categories—(1) In general.* Those expenses which cannot be allocated must be apportioned among the RPII, nonRPII, and SCI categories.

(2) *Life insurance companies—(1) Investment deductions.* A controlled foreign corporation that would be taxable under part I of subchapter L

(relating to life insurance companies) if it were a domestic insurance company shall apportion to the RPII, nonRPII, and SCI categories its deductions that are allocable or apportionable to investment income under §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T in the same proportion that investment income for the current taxable year is apportioned to those categories under § 1.953-4(c).

(ii) *Other deductions.* A controlled foreign corporation that would be taxable under part I of subchapter L (relating to life insurance companies) if it were a domestic insurance company shall apportion to the RPII, nonRPII, and SCI categories a deduction that is not allocable or apportionable to investment income under §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T in the same proportion as the numerator in paragraph (b)(2)(ii)(A) of this section bears to the denominator in paragraph (b)(2)(ii)(B) of this section.

(A) *Numerator.* For purposes of this paragraph (b)(2)(i) the numerator equals:

(1) The amount of premiums determined under section 803(a)(1) allocable to the income category, plus

(2) The decrease in section 807(c) items allocable to the income category as determined under section 807(a), minus

(3) The increase in section 807(c) items allocable to the income category as determined under section 807(b).

(B) *Denominator.* For purposes of this paragraph (b)(2)(ii) the denominator equals:

(1) The amount of premiums determined under section 803(a)(1) for all categories of income, plus

(2) The decrease in section 807(c) items for all categories of income as determined under section 807(a), minus

(3) The decrease in section 807(c) items for all categories of income as determined under section 807(b).

(3) *Property and casualty companies—(1) Investment deductions.*

A controlled foreign corporation that would be taxable under part I of subchapter L (relating to insurance companies other than life companies) if it were a domestic insurance company shall apportion to the RPII, nonRPII, and SCI categories its deductions that are allocable or apportionable to investment income under §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T in the same proportion that investment income for the current taxable year is apportioned to those categories under § 1.953-4(c).

(ii) *Other deductions.* A controlled foreign corporation that would be

taxable under part I of subchapter L (relating to insurance companies other than life insurance companies) if it were a domestic insurance company shall apportion to the RPII, nonRPII, and SCI categories a deduction that is not allocable or apportionable to investment income under §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T in the same proportion that the premiums earned, as defined in section 832(b)(4), allocated to a particular income category bears to the total of the premiums earned in all of the income categories.

(c) *Allocation and apportionment of deductions between premium and investment income after the deductions have been allocated or apportioned to the SCI or RPII categories—(1) In general.* Deductions within the SCI category must be allocated to or apportioned between premium income and investment income. Deductions within the RPII category must be allocated to or apportioned between premium and investment income if an election is made under section 953(c)(3)(C) (relating to the treatment of RPII income as effectively connected with the conduct of a United States trade or business) and under section 831(b) (alternative tax for certain small companies). Allocation and apportionment of deductions to or between premium and investment income within the SCI category and, if applicable, the RPII category is made in accordance with §§ 1.861-8, 1.861-9T, 1.861-10T, 1.861-12T and paragraph (c)(3) of this section.

(2) *Examples.* The following examples illustrate the rule of paragraph (c)(1) of this section.

Example 1. X is a life insurance company that issues policies insuring the lives of persons residing in X's country of incorporation. X requires its insureds to undergo medical examinations by physicians approved and paid by X. Under the principles of §§ 1.861-8, 1.861-9T, 1.861-10T, and 1.861-12T and this section, the medical expenses paid by X are allocable to the class of gross income consisting of X's SCI premiums.

Example 2. Z is a life insurance company that issues policies only in its country of incorporation. Z has an investment department that is in charge of investing Z's funds. The amount expended by Z in compensating the employees of its investment department is allocable under the principles of § 1.861-8 and this section to the class of gross income consisting of Z's SCI investment income.

(3) *Apportionment of reserves, losses, policyholder dividends, and policy acquisition expenses and certain other deductions between investment and*

premium income—(i) *In general.* For taxable years beginning on or after April 17, 1991, the amount of the deduction for reserves, the deduction for losses, the deduction for policyholder dividends, the deduction for policy acquisition expenses, and certain other deductions apportioned against investment income within the SCI category and, if applicable, the RPII category, shall be—

(A) The amount of investment income required to be added to reserves and required to fund losses without the SCI and, if applicable, the RPII category as computed in paragraph (c)(3)(iii) of this section;

(B) Investment income's proportionate share of policyholder dividends within the SCI and, if applicable, the RPII category as determined under paragraph (c)(3)(iv) of this section; and

(C) The amount of policy acquisition expenses and certain other deductions determined under paragraph (c)(3)(v) of this section.

The remainder of the deductions for reserves, losses, policyholder dividends, policy acquisition expenses, and certain other deductions within the SCI and, if applicable, the RPII category shall be apportioned against and reduce premium income. For taxable years beginning prior to April 17, 1991, a taxpayer may use a reasonable apportionment formula.

(ii) *Deduction for reserves and losses defined.* For purposes of paragraph (c)(3)(i) of this section, the phrase "deduction for losses" means current year deductions for claims, benefits, and losses under section 805(a)(1) (other than discounted unpaid losses under section 846), losses paid under section 832(b)(5)(A)(i), and unpaid losses on life insurance contracts. The phrase "deduction for reserves" means, for purposes of paragraph (c)(3)(i) of this section: the increase in section 807(c) reserves, as adjusted by section 807(b), of a foreign life insurance company; the increase in section 807(c)(1) reserves, as adjusted under section 807(b), included in unearned premiums of a foreign property and casualty company; and the increase in section 846 discounted unpaid losses as computed under section 832(b)(5)(ii).

(iii) *Investment income required to be added to reserves and required to fund losses.* The total amount of investment income required to be added to reserves and to fund current year losses within the SCI and, if applicable, the RPII category is computed as the sum of the following:

(A) The investment income portion of current year losses within the SCI and, if

applicable, the RPII category: This amount is the excess of—

(1) The amount of current year losses within the appropriate category, less

(2) The amount of current year losses within the appropriate category divided by one plus one-half of the annual interest rate specified in § 1.953-6(e)(4) for computing reserves.

(B) The investment income portion attributable to current-year premiums that have been added to reserves within the SCI and, if applicable, the RPII category: This amount shall be computed as—

(1) The amount of current-year premiums added to reserves within the appropriate category multiplied by one-half of the annual interest rate specified in § 1.953-6(e)(4) for computing reserves, or

(2) If the amount of current-year premiums added to the reserves is not known, the excess of—

(i) The year-end reserves within the appropriate category attributable to current-year premiums within the appropriate category, less

(ii) The year-end reserves within the appropriate category divided by one plus one-half of the annual interest rate specified in § 1.953-6(e)(4) for computing reserves.

(C) The investment income portion attributable to reserves within the SCI and, if applicable, the RPII category existing as of the end of the preceding taxable year and still in existence as of the end of the current taxable year: This amount shall be computed as the excess of—

(1) The amount of the reserves within the appropriate category at the end of the taxable year, less the sum of the amount of reserves within the appropriate category attributable to current-year premiums plus the investment income portion attributable to current-year premiums as computed under paragraph (c)(3)(iii)(B) of this section, over

(2) The amount obtained by dividing the amount computed under paragraph (c)(3)(iii)(C)(1) of this section by one plus the annual interest rate specified in § 1.953-6(e)(4) for computing reserves.

(D) If the amount of a reserve within the SCI and, if applicable, the RPII category is increased because of any actuarial redetermination, the investment income portion of the increase shall be treated as the amount of the adjustment multiplied by a fraction, the numerator of which is the amount of reserves within the appropriate category that have been deducted against gross investment income under paragraph (c)(3)(iii)(B) and (D) of this section during the five

taxable years preceding the current taxable year (or for the life of the corporation preceding the current taxable year if the foreign corporation has been in existence for less than five taxable years), and the denominator of which is the total amount of deductions attributable to reserves within the appropriate category during the five taxable years preceding the current taxable year (or for the life of the corporation preceding the current taxable year, as may be applicable).

(iv) *Investment income's proportionate share of policyholder dividends.* For purposes of this paragraph (c)(3), investment income's proportionate share of policyholder dividends, as defined in section 808 (a) and (b) and section 832(c)(11), is an amount equal to the deduction for policyholder's dividends determined under sections 805, 809, and 832(c)(11) for the taxable year multiplied by a fraction, the numerator of which is gross investment income within the SCI and, if applicable, the RPII category, for the taxable year, reduced by the amounts determined under paragraph (c)(3)(i)(A) of this section, and the denominator of which is total gross income within the appropriate category reduced by the excess, if any, of the closing balance of items described in section 807(c) or discounted unpaid losses under section 846 within the appropriate category, over the opening balance of such items and losses within the appropriate category. For purposes of paragraph (c)(3)(iv) of this section, the denominator of the fraction shall be determined by including tax-exempt interest and by applying section 807(a)(2)(B) as if it did not contain section 807(a)(2)(B)(i) thereof.

(v) *Apportionment of policy acquisition expenses and certain other deductions.* For purposes of this paragraph (c)(3), specified policy acquisition expenses, as defined in section 848(c)(1), and general deductions, as defined in section 848(c)(2), shall be apportioned to investment income within the SCI category and, if applicable, the RPII category, in the same proportion as the numerator in paragraph (c)(3)(v)(A) of this section bears to the denominator in paragraph (c)(3)(v)(B) of this section.

(A) *Numerator.* For purposes of this paragraph (c)(3)(v), the numerator equals the amount of investment income allocated or apportioned to the SCI category and, if applicable, the RPII category, minus the amount of the deduction for reserves apportioned to investment income under this paragraph (c)(3), to the extent that such reserves

qualify as life insurance reserves within the meaning of section 816(b).

(B) *Denominator.* For purposes of this paragraph (c)(3)(v), the denominator equals the amount of premium income allocated or apportioned to the SCI category and, if applicable, the RPII category, plus the amount determined under paragraph (c)(3)(v)(A) of this section. For purposes of paragraph (c)(3)(v)(B) of this section, premium income is the amount of premiums with the meaning of section 803(a)(1) and (b), in the case of a controlled foreign corporation that would be taxable under part I of subchapter L (relating to life insurance companies) if it were a domestic insurance company. In the case of a controlled foreign corporation that would be taxable under part II of subchapter L (relating to insurance companies other than life companies) if it were a domestic insurance company, premium income is the amount of premiums within the meaning of section 832(b)(4). All computations entering into the determination of premium income for purposes of paragraph (c)(3)(v)(B) of this section shall be made in the manner required under section 811(a) for life insurance companies.

The fraction set forth in this paragraph (c)(3)(v), determined for each taxable year, applies to the amount of specified policy acquisition expenses computed under section 848(c)(1) for that taxable year, which are capitalized and allowed as a deduction in such taxable year and in subsequent taxable years in accordance with section 848(a). The fraction set forth in this paragraph (c)(3)(v), determined for each taxable year, also applies to the amount, if any, by which general deductions (as defined in section 848(c)(2)) deductible in such taxable year exceed specified policy acquisition expenses for such year (as computed and capitalized under section 848). Such general deductions are subject to the apportionment formula set forth in this paragraph (c)(3)(v), even if the capitalization requirements of section 848 do not apply to the company or to certain contracts issued by it. For purposes of this paragraph (c)(3)(v), the terms "net premiums" and "general deductions," as defined in sections 848(d) and 848(c)(2), respectively, shall be computed by taking into account only amounts that have been allocated or apportioned to the SCI category and, if applicable, the RPII category.

(vi) *Example.* The following example demonstrates the calculation of the amount of investment income required to be added to reserves and fund losses under paragraph (c)(3)(i) of this section.

Example. X is a country F controlled foreign corporation that has income from issuing life insurance contracts to persons who reside in country F. At the end of its 1988 taxable year, X has a reserve under section 807(c)(1) of \$12,292 of which \$7,000 is from the addition of current-year premiums plus \$350 of investment income attributable to those premiums. At the end of the 1987 taxable year X's reserves were \$7,350. Thus, X's reserves have increased a total of \$4,942. X paid \$3,000 in death benefits in 1988. The appropriate interest rate for computing X's life insurance reserves on all of X's policies is 10% per annum, the amount of reserves and losses apportioned to premium and investment income is computed as follows:

(i) *The investment income portion of X's current year losses paid:*

$$\text{Losses} - [\text{Losses}/(1 + .5(10\%))] \\ \$3,000 - (3,000/1.05) = \$142.86$$

(ii) *The investment income portion of X's current year premiums that have been added to reserves:*

There are two methods for computing this amount:

(a) Current year premiums added to reserves $\times .5$ (annual interest rate for determining reserves).

$$\$7,000 \times .05 = \$350$$

(b) Year-end reserves attributable to current-year premiums less (such year-end reserves divided by $1 + .5$ (annual interest rate)).

$$\$7,350 - [\$7,350/(1 + .5(10\%))] = \$7.35 \\ 0 - \$7,000 = \$350.$$

(iii) *The investment income portion attributable to section 807(c) reserves existing at the end of the preceding taxable year that were in existence at the end of the current taxable year.*

[Year-end reserves less the sum of reserves attributable to current-year premiums plus the investment income portion attributable to current-year premiums minus the amount obtained in the previous term divided by $(1 + 10\%)$]

$$[\$12,292 - (\$7,000 + \$350)] - [(\$7,350 - \\ (\$7,000 + \$350))/1.10] = \$4,942 - \$4,492.72 = \\ \$449.28$$

Thus, of \$3,000 in losses, \$142.86 is apportioned to gross investment income and \$2,857.14 is allocated to premium income. Of the \$4,942 increase in reserves \$350 is the amount of investment income required to be added to current-year premiums and \$449.28 is the amount of investment income required to be added to reserves that were in existence throughout the year. Thus, \$799.28 of the \$4,942.28 increase in reserves is apportioned to investment income and \$4,142.72 (\$4,942 - \$799.28) of the increase in reserves is apportioned to premiums income.

(4) *Alternative method for life insurance companies—(i) In general.* As an alternative to the computations required by paragraph (c)(3)(i) of this section, a controlled foreign corporation that would be subject to part I of subchapter L if it were a domestic insurance company may apportion against investment income within the

SCI and, if applicable, the RPII category, the deductions for reserves, losses, and policyholder dividends in an amount equal to the policy interest plus gross investment income's proportionate share of policyholder dividends as computed under section 812(b), the remaining amount if any, of the deductions for reserves, losses, and policyholder dividends shall be apportioned to gross premiums income.

(ii) *Example.* The following example demonstrates the principles of paragraph (c)(4)(i) of this section.

Example. X is a controlled foreign corporation that would be taxable as a life insurance company under part I of subchapter L if it were a domestic insurance company. In 1988, X has a reserve of \$1,000. In 1989, X has a reserve of \$1,500. Under section 812(b)(2)(A), and using the interest rate prescribed in § 1.953-6(e)(4) for computing reserves, X has policy interest equal to \$200. Rather than using the method set forth in paragraph (c)(3)(i) of this section, the increase in reserves may be apportioned between premium and investment income by apportioning the policy interest to investment income and by apportioning the increase in the reserves less the policy interest against premium income. Thus, \$200 is apportioned to investment income and \$300 (\$500 - \$200) is apportioned to premium income.

(5) *Losses in excess of premium or investment income.* If the total amount of deductions allocated and apportioned to premium income within the RPII and nonRPII categories exceeds the amount of premium income within those categories, then the excess shall be allocated to investment income within the same category. If the total amount of deductions allocated and apportioned to premium income within the SCI category exceeds the amount of premium income within that category, then the excess shall not be allocated to investment income within the SCI category and shall not be allocated to any other category of subpart F income. However, if an election is made under section 952(c)(1)(B)(vii), the deductions allocated and apportioned to premium income within the SCI category shall be allocated to investment income within the SCI category. If the total amount of deductions allocated or apportioned to investment income within each of the RPII and nonRPII categories exceeds the amount of investment income within those categories, then the excess deductions shall be allocated to premium income within the same category. If the total amount of deductions allocated or apportioned to investment income within the SCI category exceeds the amount of investment income within that category, then the excess deductions shall be

allocated to the RPII or nonRPII categories in accordance with paragraph (c)(8) of this section. However, if an election is made under section 952(c)(1)(B)(vii), deductions allocated or apportioned to investment income with the SCI category that exceed the income within that category shall first reduce premium income within the same category.

(b) *Losses within the RPII, nonRPII, and SCI categories.* If, after allocating and apportioning deductions, there is a loss within the RPII or nonRPII categories, within the investment income portion of the SCI category, or, if an election is made under section 952(c)(1)(B)(vii), within the entire SCI category, then a loss in one category will be treated as reducing income in another category only for purposes of calculating the pro rata share of RPII, nonRPII, or SCI income to be included by United States shareholders as defined in section 951(b). Thus, persons that are United States shareholders solely by virtue of section 953(c)(1)(A) may not use a loss within the nonRPII or SCI categories to reduce income within the RPII category.

§ 1.953-4 Application of subchapter L and certain sections of subchapter I of the Code.

(a) *Applicability of subchapter L—(1) In general.* A controlled foreign corporation which has insurance income under section 953 or foreign personal holding company income that is SCI investment income shall compute its insurance income or SCI investment income either under part I of subchapter L of the Code (relating to life insurance companies) or under part II of subchapter L of the Code (relating to other insurance companies) as modified by this section and § 1.952-2. If a controlled foreign corporation does not file an annual statement with an insurance regulatory authority of any State, such corporation must complete those portions of the annual statement prescribed by the National Association of Insurance Commissioners which are necessary to make the determinations and computations required under subchapter L of the Code. If a controlled foreign corporation uses the reserves described in paragraph (d)(1)(ii) of this section (relating to reserves on United States business for which no NAIC statement is required) to qualify as a life insurance company subject to part I under subchapter L, then the foreign corporation shall compute its reserves, for purposes of the NAIC annual statement, by following the laws and regulations of New York or the laws of the State of the United States where the

insured risks are located, whichever is applicable under paragraph (d)(1)(ii) of this section. In all other circumstances, the controlled foreign corporation shall complete the necessary portion of the NAIC annual statement by following the rules prescribed in §§ 1.953-1 through 1.953-7 and, to the extent not inconsistent with those sections, the rules prescribed by the National Association of Insurance Commissioners.

(2) *Applicability of section 7702.*

[Reserved]

(3) *Applicability of section 817.*

[Reserved]

(b) *Special rules regarding use of subchapter L to compute RPII, nonRPII, and SCI income—(1) Certain provisions not to apply.* The following provisions of subchapter L do not apply in computing section 953 insurance income or foreign personal holding company income that is SCI investment income:

(i) Section 806, relating to the small life insurance company deduction;

(ii) Section 805(a)(5), relating to the operations loss deduction; and

(iii) Section 832(c)(5), relating to certain capital losses.

(2) *Allocation and apportionment of certain items.* The items referred to in section 803(s)(1) (relating to gross amount of premiums and other considerations), section 803(s)(2) (relating to net decrease in reserves), section 805(a)(2) (relating to net increase in reserves), and section 832(b)(4) (relating to premiums earned on insurance contracts) shall be taken into account in computing income within a particular category, whether the RPII, nonRPII, and SCI categories, on to the extent they relate to a contract issued or reinsured by the controlled foreign corporation that gives rise to premiums within that particular category. For rules relating to the allocation of premiums, see §§ 1.953-2 and 1.953-3. For rules relating to increases or decreases in reserves, see §§ 1.953-4 and 1.953-6.

(c) *Alternative tax for certain small companies.* Any controlled foreign corporation that computes its taxable income under part II of subchapter L (relating to insurance companies other than life insurance companies) and makes the election under § 1.953-7(c) to have its related person insurance income treated as effectively connected with the conduct of a trade or business in the United States may elect to have its related person insurance income, as well as its income effectively connected with the conduct of a United States trade or business that is excluded from subpart F income under section 952(b), taxed under section 871(b) (alternative

tax for certain small companies) if the requirements of that section are met. To determine whether a corporation meets the net written premium requirement of section 871(b), the premiums on all policies (including SCI policies) of insurance or reinsurance or annuity contracts issued by the corporation must be taken into account.

(d) *Computation of reserves to determine applicability of part I of subchapter L—(1) Reserves required by law.* The reserves set forth in this paragraph (d)(1) are the only reserves to be taken into account as reserves required by law under section 818(b)(2) to determine for any taxable year whether a controlled foreign corporation is subject to part I of subchapter L (relating to life insurance companies):

(i) *Reserves with respect to United States business.* The reserves which are required by the law of the state or states of the United States, including the District of Columbia, to which the business of the controlled foreign corporation is subject, but only with respect to its United States business, if any, which is taxable under section 842(a).

(ii) *Reserves deemed to be required.* To the extent the controlled foreign corporation is not subject to section 842(a) but issues a policy of insurance or an annuity contract to a resident of the United States—

(A) Except as provided in paragraph (d)(1)(ii)(B) of this section, the reserves that would be required by applying the minimum standards of the law of New York as if the controlled foreign corporation were an insurance company transacting all of its insurance business (other than its insurance business carried on within the United States that is subject to section 842(a)) for the taxable year in New York; and

(B) With respect to all United States risks covered by insurance ceded to the controlled foreign corporation by an insurance company subject to subchapter L of the Code, determined without regard to section 501, and in respect of which an election is made by or on behalf of the controlled foreign corporation to determine its reserves in accordance with paragraph (d)(1)(ii)(B) of this section, the amount of reserves against such risks which would result if the reserves were determined by applying the law of the state of the United States where the risks are located as if the controlled foreign corporation were an insurance company in that state engaged in reinsuring the risks.

(iii) *Reserves with respect to foreign business.* In the case of a reserve on a

contract that is not described in paragraph (d)(2)(i) and (ii) of this section, the reserve determined under the laws, regulations, or administrative guidance of the insurance regulatory authority of the home country, or the reserve determined under the laws of the country of residence of the insured, if the controlled foreign corporation is subject to the insurance regulatory authority of the insured's country of residence. If the reserves of a controlled foreign corporation are subject to the laws of more than one foreign jurisdiction, the amount of reserves taken into account shall be the largest reserve required by any such foreign jurisdiction. If neither the home country nor the country of residence of the insured require reserves to be established, then the reserve shall be computed using the mortality tables prescribed by section 807(d) but using the interest rate prescribed in paragraph (e)(4) of this section applicable to qualified contracts.

(2) *SCI reserves to be taken into account.* The total reserves of a controlled foreign corporation are taken into account to determine whether the corporation is to compute its taxable income under part I of subchapter L. Thus, reserves which relate to the lives or health of residents of the home country are taken into account.

(e) *Computation of reserves for purposes of computing taxable income—*

(1) *Actual reserves required.* For all purposes of §§ 1.953-1 through 1.953-7, a controlled foreign corporation will be considered to have a reserve only to the extent the reserve has been actually held during the taxable year for which the reserve is claimed.

(2) *Life insurance reserves.* For purposes of computing the taxable income from insurance operations, the section 807(c)(1) items of a controlled foreign corporation that would be taxable under part I or part II of subchapter L of the Code if it were a domestic insurance company that are related to a nonqualified contract, as defined in this paragraph, shall be determined under the rules of section 807(d). The amount of life insurance reserves under section 807(c)(1) relating to qualified foreign contracts shall be determined under the rules of section 807(e)(4) and paragraph (e)(4) of this section. For purposes of this paragraph, a qualified foreign contract means a contract insuring life or health issued by a controlled foreign corporation if the person with the determining life, as defined in § 1.953-2(c)(1), is a resident of the country in which the controlled foreign corporation is incorporated and

such country is not contiguous to the United States. A nonqualified foreign contract is any contract that is not a qualified foreign contract.

(3) *Discounted unpaid losses of a property and casualty company.* If a controlled foreign corporation would be taxable under part II of subchapter L of the Code if it were a domestic insurance company or if it would be subject to part I but has discounted unpaid losses as defined in section 848, the amount of its discounted unpaid losses shall be determined under the rules of section 848 except to the extent modified by paragraph (e)(4) of this section.

(4) *Interest rates used for determining reserves—* (i) *Qualified foreign contracts and property and liability contracts.* For purposes of applying section 807(d)(2)(B) and section 812(b)(2)(A) to qualified foreign contracts as defined in paragraph (e)(2) of this section, the term "prevailing State assumed interest rate" shall mean the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance contracts or annuity contracts under the laws of each country in which the controlled foreign corporation conducts an insurance business. For purposes of applying sections 807 and 812 to qualified foreign contracts, as defined in paragraph (e)(2) of this section, and for purposes of applying section 848 to contracts covering risks located outside the United States, the applicable federal interest rate shall be a foreign currency rate of interest analogous to the applicable federal mid-term rates as defined in section 1274(d), but based on annual compounding. An analogous foreign currency rate of interest is a rate of interest based on yields (with an appropriate compounding period) of the highest grade of outstanding marketable obligations denominated in the currency of the country pursuant to the laws of which the controlled foreign corporation computes its reserves (excluding any obligations that benefit from special tax exemptions or preferential tax rates not available to debt instruments generally), with due consideration given to the maturities of the obligations. If a controlled foreign corporation that would be subject to part II of subchapter L if it were a domestic insurance company uses the loss payment patterns prescribed by the Secretary under section 848(d) for discounting unpaid losses (rather than the company's historical payment pattern as permitted under section 848(e)), the company must compute the year-end discounted fraction of unpaid losses and the reserve discount factors by using the applicable

federal interest rate required by this paragraph and may not use the year-end discounted fraction of unpaid losses and the reserve discount factors prescribed by the Secretary for any accident year.

(ii) *Nonqualified foreign contracts.* For purposes of applying sections 807 and 812 to nonqualified foreign contracts, as defined in paragraph (e)(2) of this section, the prevailing state assumed interest rate shall be the rate defined in section 807(d)(4)(E) and the applicable federal interest rate shall be the rate defined in section 807(d)(4)(A).

(f) *Corporations not qualifying as insurance companies—* (1) *In general.* The United States shareholders of a controlled foreign corporation must include their pro rata share of that corporation's section 953 insurance income even if the foreign corporation would not be taxed under subchapter L of the Code if it were a domestic corporation. Such a corporation shall compute its section 953 insurance income and its foreign personal holding company income that is SCI investment income under the rules of part I or part II of subchapter L as modified by section 953(b) and §§ 1.953-1 through 1.953-7, to the extent not inconsistent with the rules of this paragraph, as if it were a domestic insurance company. A controlled foreign corporation will compute its insurance income as if it were a domestic insurance company subject to part I of subchapter L (relating to life insurance companies) only if it can meet the requirements of section 816(a) of the Code taking into account only that portion of its business which involves the issuing or reinsuring of insurance or annuity contracts. If the requirements of section 816(a) cannot be met, then the controlled foreign corporation must compute its insurance income under part II of subchapter L.

(2) *Items of gross income attributable to insurance operations of a non-insurance company—* (i) *Corporations computing taxable income under part I of subchapter L.* The taxable income of a controlled foreign corporation described under paragraph (f)(1) of this section that computes its insurance income under part I of subchapter L shall include in its insurance income, together with the items of gross income that directly relate to its life insurance business, the items of income described in section 803(a)(3) which are not directly related to its insurance business, and which are not directly related to any other trade or business, in the proportion that the numerator determined under paragraph (f)(2)(i)(A) of this section bears to the denominator

determined under paragraph (f)(2)(i)(B) of this section.

(A) *Numerator.* The numerator used for the apportionment under paragraph (f)(2)(i) of this section is the sum of the means of the items described in section 607(c) at the beginning and end of the taxable year.

(B) *Denominator.* The denominator used for the apportionment under paragraph (f)(2)(ii) of this section is the mean of the value of the total assets held by the controlled foreign corporation at the beginning and the end of the taxable year, determined by taking bills, accounts, notes receivable, and open accounts at face value and all other assets at their adjusted basis under section 1011 of the Code, unless there is affirmative evidence that more accurately reflects the value of the assets.

(ii) *Example.* The following example illustrates the principles of paragraph (f)(2)(i) of this section.

Example. X is a controlled foreign corporation incorporated in country M engaged in the business of selling product V. It uses the calendar year as its taxable year. All of X's sales are to persons who reside outside of country M. A division of X issues contracts of credit life insurance to ensure payment of the purchase price of X's products. X does not, however, do enough business as an insurer to qualify as an insurance company under subchapter L of the Code. In 1992, X receives \$500 in premiums and \$3,000 in sales from product V. X also has interest, dividends, and gains from the sale of investment properties in the amount of \$10,000. The investment income is not specifically allocable to the insurance or non-insurance businesses. The mean of X's reserves under section 607(c) determined as of the beginning and end of 1992 is \$1,000. The mean of the value of X's total assets held at the beginning and the end of the taxable year is \$5,000. The \$3,000 received as part of the sales price of product V are directly related to V's non-insurance business and do not constitute insurance income. The \$500 in premiums are directly related to V's insurance business and do constitute insurance income under section 653. Of X's \$10,000 in investment income \$2,000 ($\$10,000 \times \$1,000/\$5,000$) is insurance income under section 653.

(iii) *Corporations computing taxable income under part II of subchapter L.* The taxable income of a controlled foreign corporation described in paragraph (f)(1) of this section that computes its insurance income as if it were a domestic insurance company subject to part II of subchapter L shall include in its insurance income, together with the items of gross income that directly relate to its insurance business, the items of income described in section 832(b)(1) which are not directly related to its insurance business, and which are

not directly related to any other trade or business, in the proportion that the numerator determined under paragraph (f)(2)(iii)(A) of this section bears to the denominator determined under paragraph (f)(2)(iii)(B) of this section.

(A) *Numerator.* The numerator used for the apportionment under paragraph (f)(2)(iii) of this section is the sum of—

(1) The mean of the controlled foreign corporation's unearned premiums at the beginning and end of the taxable year, determined under section 632(b)(4)(B);

(2) The mean of the controlled foreign corporation's discounted unpaid losses at the beginning and end of the taxable year, determined under section 548; plus

(3) The mean of the items described in section 607(c)(4) at the beginning and end of the taxable year, to the extent allowable under section 832(c)(11).

(B) *Denominator.* The denominator used for the apportionment under paragraph (f)(2)(iii) of this section is the mean of the value of the total assets held by the controlled foreign corporation at the beginning and the end of the taxable year, determined by taking bills, accounts, notes receivable, and open accounts at face value and all other assets at their adjusted basis under section 1011 of the Code, unless there is affirmative evidence that more accurately reflects the value of the assets.

(g) *Relationship between sections 653 and 954—(1) Priority of application—(i)*

In general. For purposes of determining the subpart F income of a controlled foreign corporation, the provisions of section 653 and §§ 1.953-1 through 1.953-7 must be applied before the provisions of section 954 (relating to foreign base company income). Further, the provisions of section 954 apply only to income that is not insurance under section 953. For example, the provisions of section 954 are applied to the investment income attributable to premiums received with respect to insured risks located in the controlled foreign corporation's country of incorporation only after §§ 1.953-1 through 1.953-7 have been applied to determine the amount of section 953 insurance income and SCI income and the deductions allocated and apportioned to those categories of income. Notwithstanding the foregoing, foreign base company oil related income as defined in section 954 (a)(5) and (g) shall not be treated as insurance income subject to section 953 and shall not be subject to §§ 1.953-1 through 1.953-7.

(ii) *Examples.* The following examples illustrate the principles of paragraph (g)(1)(i) of this section.

Example 1. X is a controlled foreign corporation incorporated in country F. X's

only trade or business is the insurance business. All of X's premiums are received under contracts insuring risks located outside country F. X earns interest, dividends, and rents from the investment of the premiums it receives. The interest, dividends, and rents are insurance income under section 653 and not foreign personal holding company income under section 954.

Example 2. Y is a controlled foreign corporation incorporated in country W. Y owns all of the outstanding stock of Z, also a country W corporation. Y writes contracts that give rise to premiums allocable to the nonRPII and SCI categories, in its taxable year ending in 1992. Y receives a dividend from Z. Y must allocate or apportion that dividend income to the nonRPII and SCI categories under § 1.953-4 before applying the exception of section 954(c)(3) (relating to dividends from same-country related corporations) to the SCI investment income.

(2) *Decrease or increase in income not material—(i) In general.* For purposes of computing the subpart F income of a controlled foreign corporation deriving income from insurance, reinsurance, or annuity contracts, deductions are allowed if they are allowed under subchapter L of the Code as modified by section 953 regardless of whether they are allocated or apportioned to section 953 insurance income or SCI investment income which constitutes section 954(c) foreign personal holding company income. Further, the amount of section 953 insurance income and the amount of foreign personal holding company income attributable to SCI investment income shall be determined in accordance with subchapter L of the Code, as modified by section 953, even though those rules result in a greater amount of subpart F income compared to the amount determined under section 954. Thus, in applying section 953 to income of a controlled foreign corporation that would, but for section 953, be subject to the provisions of section 954, the exceptions under section 954(c) which would not require a United States shareholder to include its gross income dividends, interest, rents, royalties, gains from the sale or exchange of property described in section 954(c)(1)(B), net gains from commodities transactions described in section 954(c)(1)(C), and net gains from foreign currency transactions described in section 954(c)(1)(D), are irrelevant.

(ii) *Examples.* The principles of this paragraph (g)(2) are illustrated in the following examples.

Example 1. Z is a controlled foreign corporation that only issues and reissues property and casualty insurance policies covering home country risks. Z may allocate a part of its discontinued unpaid losses under section 948 to its SCI investment income

which is foreign personal holding company income under section 954(c).

Example 2. Y, a controlled foreign corporation, receives dividends and interest from a subsidiary which is incorporated in the same country as X and has a substantial part of its trade or business assets located in that country. All of X's income is attributable to the RPI or nonRPI categories. The dividends, after the appropriate allocation and apportionment, are included in the gross income of X's United States shareholders without regard to section 951(c)(3) (relating to dividends and interest from same-country related corporations).

(h) *Inclusion of pro rata share of subpart F income derived from insurance operations*—(1) *Inclusion of pro rata share of related person insurance income.* Each section 953(c) shareholder, as defined in this paragraph (h)(1), must include in its gross income (subject to the section 952(c) earnings and profits limitation) the lesser of—

(i) The "pro rata amount," which is the amount that would be determined under section 951(a)(2) if only related person insurance income were taken into account; if the number of shares of stock owned (within the meaning of section 958(a)) by section 953(c) shareholders in the aggregate on the last day of the taxable year were the total number of shares in the foreign corporation; and if only distributions received by section 953(c) shareholders were taken into account under section 951(a)(2)(B); or

(ii) The "limitation amount," which is the amount that would be determined under section 951(a)(2) if all of the taxable income of the foreign corporation for the taxable year were subpart F income. A section 953(c) shareholder is a United States shareholder as defined in section 953(c)(1)(A) and section 1.953-3(b)(2) and includes a United States shareholder as defined in section 951(b).

(2) *Inclusion of subpart F income other than related person insurance income.* Each United States shareholder as defined in section 951(b) (a "section 951(b) shareholder") must include, in addition to its pro rata share of income within the RPI category computed under paragraph (h)(1) of this section, its pro rata share of subpart F income other than related person insurance income, as computed under section 951(a)(2) and paragraph (h)(3) of this section. A section 951(b) shareholder must include its pro rata share of income within the RPI category as computed under this paragraph (h)(2) regardless of whether the exceptions of section 953(c)(3) (A) and (B) and section 1.953-7 (a) and (b) apply.

(3) *Earnings and profits limitation.*

Pursuant to section 952(c)(1)(A), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such taxable year. Thus, a United States shareholder's inclusion of subpart F income shall not exceed such shareholder's pro rata share, computed under the principles of section 951(a)(2), of the earnings and profits of the controlled foreign corporation. If the sum of a United States shareholder's pro rata share of related person insurance income and subpart F income other than related person insurance income exceeds such shareholder's pro rata share of the controlled foreign corporation's earnings and profits, then the section 952(c)(1)(A) earnings and profits limitation shall be applied by first including the United States shareholder's pro rata share of related person insurance income.

(4) *Examples.* The following examples illustrate the principles of paragraph (b) of this section.

Example 1. X is a country M corporation and is a controlled foreign corporation under section 957, section 953(c)(1)(B), and § 1.953-3(b)(2). It has 100 shares of one class of stock outstanding. A owns 5 shares, B owns 5 shares, C owns 70 shares, and F owns 20 shares. A, B, and C are unrelated United States persons; F is a foreign person. A, B, and C are considered section 953(c) shareholders. Only C, however, is a section 951(b) shareholder. During the current taxable year, X has \$1,000 of related person insurance income and \$1,000 of earnings and profits. A and B will each include \$50 and C will include \$700 of related person insurance income in gross income, computed as set forth below.

Computation of pro rata share of related person insurance income.

Lesser of:
Pro rata amount:
A: $5/80 \times \$1,000 = \62.50
B: $5/80 \times \$1,000 = \62.50
C: $70/80 \times \$1,000 = \875.00

or
Limitation amount:
A: $5/100 \times \$1,000 = \50
B: $5/100 \times \$1,000 = \50
C: $70/100 \times \$1,000 = \700

Example 2. The facts are the same as in Example 1 except that there is \$2,000 of related person insurance income and \$1,500 of earnings and profits. The amount of related person insurance income included in gross income of A, B, and C is \$75, \$75, and \$1,650, respectively, as computed below.

(i) *Computation of pro rata share of related person insurance income.*

Lesser of:
Pro rata amount:
A: $5/80 \times \$2,000 = \125
B: $5/80 \times \$2,000 = \125
C: $70/80 \times \$2,000 = \$1,750$

or

Limitation amount:
A: $5/100 \times \$2,000 = \100
B: $5/100 \times \$2,000 = \100
C: $70/100 \times \$2,000 = \$1,400$

(ii) *Computation of section 952(c)(1)(A) earnings and profits limitation.*

A: $5/100 \times \$1,500 = \75
B: $5/100 \times \$1,500 = \75
C: $70/100 \times \$1,500 = \$1,050$

The amount of related person insurance income included in the gross income of each shareholder is limited by their pro rata share of earnings and profits as computed under section 952(c) because that amount is less than both the pro rata amount and the limitation amount.

Example 3. The facts are the same as in Example 1 except that X has \$1,000 in related person insurance income, \$1,000 in subpart F income other than related person insurance income, and \$1,500 in earnings and profits.

(i) *Computation of pro rata share of related person insurance income.*

Lesser of:
A: $5/80 \times \$1,000 = \62.50
B: $5/80 \times \$1,000 = \62.50
C: $70/80 \times \$1,000 = \875.00

or

Limitation amount:
A: $5/100 \times \$2,000 = \100
B: $5/100 \times \$2,000 = \100
C: $70/100 \times \$2,000 = \$1,400$

(ii) *Computation of the pro rata share of subpart F income other than related person insurance income.*

C is the only section 951(b) shareholder.
C: $70/100 \times \$1,500 = \$1,050$

(iii) *Computation of pro rata share of earnings and profits.*

A: $5/100 \times \$1,500 = \75
B: $5/100 \times \$1,500 = \75
C: $70/100 \times \$1,500 = \$1,050$

With respect to A and B, the pro rata amount of related person insurance income is less than their pro rata share of X's earnings and profits. Thus, A and B will each include \$62.50 in gross income as related person insurance income. The sum of C's pro rata share of related person insurance income (the pro rata income of \$875) and subpart F income other than related person insurance income (\$700) equals \$1,575. That sum exceeds C's pro rata share of X's earnings and profits (\$1,050). Thus, C must include \$525 of related person insurance income and \$175 (\$1,050 - \$875) of subpart F income other than related person insurance income.

(5) *Controlled foreign corporation for less than entire year*—(1) *In general.* If a foreign corporation with related person insurance income is a controlled foreign corporation for less than the entire taxable year, for purposes of computing the limitation amount, only the taxable income of the foreign corporation for that portion of the taxable year during which the foreign corporation, computed as if such income were earned ratably throughout the taxable year, shall be treated as subpart F income.

(ii) *Example.* The rule of this paragraph (h)(5) is illustrated in the following example.

Example. X, a foreign corporation, was incorporated on January 1, 1987 by A, B and F. As of that date, A and B who are United States persons, each own 5 shares and F, who is not a United States person, owns 90 shares of the 100 shares of the single class of stock issued and outstanding. On July 1, 1987, F sells 70 of his shares to C, a United States person. At the end of the calendar year, which is also X's taxable year, X has \$1,000 of income from providing insurance to its United States shareholders and persons related to those shareholders. X also has \$1,000 of earnings and profits for the year. A and B must each include \$25.00 in gross income and C must include \$348.00. The computations necessary to determine related person insurance income are set forth below.

Computation of the pro rata share of related person insurance income.

Lesser of:

Pro rata amount:

A: $5/90 \times (182/365 \times \$1,000) = \$31.00$

B: $5/90 \times (182/365 \times \$1,000) = \$31.00$

C: $70/90 \times (182/365 \times \$1,000) = \$436.00$

or

Limitation amount:

A: $5/100 \times (182/365 \times \$1,000) = \$25.00$

B: $5/100 \times (182/365 \times \$1,000) = \$25.00$

C: $70/100 \times (182/365 \times \$1,000) = \$348.00$

Thus, the amount of related person insurance income to be included by A, B, and C is the limitation amount.

(8) *Distributions*—(i) *In general.* Only distributions to United States shareholders, as defined in section 951(b) or section 953(c)(1)(A), are to be taken into account for purposes of computing the pro rata amount, as defined in paragraph (h)(1)(i) of this section. However, for purposes of computing the limitation amount under paragraphs (h)(1)(ii) of this section, distributions to shareholders other than United States shareholders shall be taken into account.

(ii) *Example.* The following example illustrates the rule of paragraph (h)(8)(i) of this section.

Example. X is a controlled foreign corporation within the meaning of section 953(c)(1) and § 1.953-3(b)(2) and has 100 shares of one class of stock outstanding. F, who is not a United States person, owned all 100 shares of X's outstanding stock until July 1, 1987, when A, a United States person, acquired 60 shares of the stock from F. On June 30, 1987, before A had acquired X's stock from F, X made a distribution of \$2 per share for a total of \$200 to F. At the end of the calendar year, which is also X's taxable year, X had \$2,000 of taxable income, of which \$1,000 is related person insurance income, of which \$1,000 is related person insurance income. X also had earnings and profits for the taxable year of \$2,000. The computation for determining A's pro rata share of related person insurance income is set forth below.

Computation of the pro rata share of related person insurance income.

(i) *Pro rata amount:*

A: $60/100 \times 182/365 \times \$1,000 = \$498.00$

(ii) *Limitation amount:*

A: $60/100 \times 182/365 \times \$2,000 = \$598.00$

minus lesser of:

\$1.20 dividend on shares purchased

$60\% \times 182/365 \times \$2,000 (\$528.00) =$

$(\$120.00)/\478.00

Thus, A must include \$478 of related person insurance income in gross income.

(7) *Mutual insurance companies.* For purposes of sections 951(a)(2) and 953(c)(5) and paragraph (h) of this section, a United States shareholder that is a policyholder in a mutual insurance company shall compute its pro rata share by reference to the amount that would be distributed with respect to the United States shareholder's policy or policies owned on the last day of the controlled foreign corporation's taxable year if all the related person insurance income and all the subpart F income other than related person insurance income were distributed to the policyholders. In making the determination of a mutual policyholder's pro rata share of subpart F income the rules set forth in paragraph (h)(7)(i) through (iii) of this section are applied in the order given and the first rule to result in the determination of a specific amount to be included in the policyholder's gross income is the rule that shall be applied. The mutual policyholder's pro rata share of subpart F income shall be determined as:

(i) The amount that would be distributed annually under the terms of the policy or the by-laws of the corporation;

(ii) The amount that would be distributed if the mutual company were liquidated; or

(iii) The amount that would be distributed to a policyholder if earnings and profits were distributed in the same proportion that premiums paid by the policyholder over a five-year period ending on the last day of the controlled foreign corporation's taxable year bears to the total amount of premiums paid by all policyholders who hold ownership interests on the last day of the taxable year and have held their interest over the five-year period.

(i) *Application of sections 958, 991, and 1248.* If a foreign corporation that is a controlled foreign corporation under section 953(c) makes a distribution with respect to its stock, section 959(a)(1) shall apply to any United States shareholder as defined in section 953(c)(1)(A) and § 1.953-3(b)(2). Earnings and profits attributable to related person insurance income included in the gross income of a United

States shareholder with less than 10 percent of the combined voting power of the stock of the controlled foreign corporation shall be treated as earnings and profits which have been included in the gross income of a United States shareholder for purposes of section 956 and 959(a)(2). In addition, the adjustments made to the basis of stock in a controlled foreign corporation required by section 961 shall apply to any United States shareholder as defined in section 953(c)(1)(A) and § 1.953-3(b)(2). Any United States person who is a United States shareholder, as defined in section 953(c)(1)(A) and § 1.953-3(b)(2), of a controlled foreign corporation, as defined in section 953(c)(1)(B) and § 1.953-3(b)(2), shall be treated as meeting the stock ownership requirements of section 1248(a)(2). In addition, any controlled foreign corporation, within the meaning of section 953(c)(1)(B) and § 1.953-3(b)(2), shall be treated as a controlled foreign corporation for purposes of section 1248.

(j) *Application of section 367(b).* [Reserved]

(k) *Interaction with section 954(b)(3).* Income that would not be considered subpart F income but for the operation of section 954(b)(3)(B) shall not be considered related person insurance income. Thus, if foreign base company income and insurance income exceed 70 percent of gross income, United States persons who are United States shareholders solely by operation of section 953(c)(1)(A) and § 1.953-3(b)(2) must include in their gross income only their pro rata share of related person insurance income. Any person who is a United States shareholder as defined in section 951(b) shall, however, include his pro rata share, as determined under this section, of the entire amount of subpart F income of the controlled foreign corporation.

§ 1.953-7 Exceptions to inclusion of related person insurance income for certain shareholders.

(a) *Corporation not held by insureds*—(1) *In general.* A person that is a United States shareholder solely by virtue of section 953(c)(1) shall not include in gross income such person's pro rata share of income that qualifies as related person insurance income if, at all times during the taxable year of the foreign corporation, less than 20 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and less than 20 percent of the total value (both stock and policies) of the corporation is owned (directly or indirectly) under the

principles of section 883(c)(4)) by persons who are the insured under any insurance or reinsurance contract, who are the purchasers or beneficiaries of any annuity contract issued or reinsured by the foreign corporation, or who are related persons (within the meaning of section 954(d)(3)) to any such insured. For purposes of this paragraph, the term "insured" means only United States persons, as defined in section 957(c), or persons related to United States persons (within the meaning of section 954(d)(3)) who are insured or reinsured by the foreign corporation, persons who have purchased or are beneficiaries under any annuity contract issued or reinsured by the foreign corporation, or persons insured by the foreign corporation in a cross-insurance arrangement described in § 1.953-3(b)(5).

(2) *Examples.* The principles of this paragraph (a) are illustrated in the following examples.

Example 1. X is a country Y corporation which issues property and liability insurance policies for risks located outside country Y. X has one class of voting stock outstanding. Z, a domestic corporation, owns 80 percent of X's stock. Z has 100 shareholders each of which owns one percent of Z. Of the remaining shareholders of X, four are foreign corporations, each of which owns five percent of the X stock, and four are domestic corporations which also own five percent each. X has issued policies of insurance to 25 of Z's shareholders, the four foreign corporations which own stock in X, and to W, one of the domestic corporate shareholders of X. None of the other shareholders of X are insured by X. The 25 insureds who own stock in Z own, indirectly under the principles of section 883(c)(4), 15 percent of the stock of X (25% x 50%). The insurance income attributable to the policy of insurance issued to W is related person insurance income that is includable in the gross income of the four domestic corporate shareholders of X because 20 percent of the stock of X is owned directly or indirectly by insureds who are United States persons: 15 percent by 25 of the shareholders of Z plus 5 percent owned by W. In addition, because Z is a United States shareholder as defined in section 951(b), as well as in section 953(c)(1), it must include its pro rata share of the related person insurance of income of X, plus the section 953(a) insurance income that is not related person insurance income, regardless of whether 20 percent or more of the corporation is owned, directly or indirectly, by insureds who are United States persons.

Example 2. Y is a controlled foreign corporation. Its one class of stock outstanding is owned equally by 20 domestic corporations, none of which are insured by Y. Nine of the shareholder corporations are the parent corporations of nine unrelated, wholly-owned foreign subsidiaries which are insured by Y. Because the insureds are related persons, within the meaning of section 954(d)(3), to United States shareholders (the domestic corporate

shareholders), the income from insuring the foreign subsidiaries is related person insurance income. Moreover, because nine domestic corporate shareholders of Y control the subsidiaries, within the meaning of section 954(d)(3), they are related persons. Therefore, 45 percent (9 x 5%) of the stock of Y is owned by United States shareholders that are related to the insureds and the exception to inclusion in gross income of paragraph (a)(1) of this section is inapplicable. The 20 domestic shareholders must include Y's related person insurance income in their gross income.

(b) *De minimus insurance exception—*
(1) *In general.* A person that is a United States shareholder solely by virtue of section 953(c)(1) shall not include in gross income such person's pro rata share of income that qualifies as related person insurance income if the related person insurance income, determined on a gross basis, of the foreign corporation is less than 20 percent of the foreign corporation's total insurance income for the taxable year, determined on a gross basis, without regard to those provisions of section 953(a)(1) and § 1.953-2(a)(1) which limit section 953 insurance income to income from countries other than the country in which the corporation was created or organized. Related person insurance income determined on a gross basis means life insurance gross income within the meaning of section 803 of gross income within the meaning of section 832(b)(1), whichever is applicable, except that the phrase "premiums earned (within the meaning of section 832(b)(4))" shall be substituted for the term "underwriting income," where that term appears in section 832(b)(1)(A).

(2) *Examples.* The following examples illustrate the principles of paragraph (b)(1) of this section.

Example 1. X is a country Y corporation engaged in the business of issuing liability insurance. All of the stock of X is owned by United States shareholders. Each of the United States shareholders owns less than 10 percent of X's one class of stock outstanding. For its 1987 taxable year, X has \$100,000 of gross income of which \$10,000 constitutes section 953 insurance income within the RPI category and \$90,000 constitutes section 953 insurance income within the nonRPI category. Of the remaining \$40,000 of income, \$10,000 would have been premium and investment income within the RPI category of section 953 insurance income and \$30,000 would have been premium and investment income within the nonRPI category of insurance income except that those amounts relate to contracts insuring risks located in the home country. Thus, without regard to the same country exception, \$20,000 of income (\$10,000 from the RPI category and \$10,000 from the nonRPI category) would have been within the RPI category of section 953 insurance income. X does not meet the de minimus insurance exception of paragraph

(b)(1) of this section because 20 percent (\$20,000/\$100,000) of its insurance income, determined without regard to those provisions of section 953(a)(1) and § 1.953-2(a)(3) which limit insurance income to income from insuring risks located outside the home country, is related person insurance income.

Example 2. The facts are the same as in *Example 1* except that \$3,000 of premiums that constitute income within the RPI category is paid to another insurer pursuant to a reinsurance contract. X does meet the de minimus insurance exception because under section 832(b)(4)(A), premiums paid for reinsurance are deducted from premiums written in arriving at premiums earned. Thus, approximately 17.5 percent (\$17,000/\$97,000) of X's insurance income is related person insurance income.

(3) *Anti-abuse rule—(i) in general.* In determining insurance income on a gross basis, the District Director may exclude income attributable to an insurance or reinsurance contract covering the life, health, property, or liability of a person other than a United States shareholder, or person related to such shareholder, or attributable to an annuity contract or a contract reinsuring annuity contracts, that are purchased by, or provide annuity payments to, a person other than a United States shareholder or person related to such shareholder, if the primary purpose for entering into the contract is to qualify for the de minimus insurance exception. See also section 845. In making this determination, the District Director will consider all the facts and circumstances. Among the factors to be considered are whether there is a true transfer of risk, whether the predominant purpose for the transaction is a bona fide business purpose, and whether the terms of the insurance or reinsurance contract reflect the terms that unrelated parties would agree to in a similar transaction.

(ii) *Examples.* The following examples illustrate the principles of paragraph (b)(3) of this section.

Example 1. The facts are the same as in *Example 1* in paragraph (b)(2) of this section, except that near the end of its taxable year, X cedes to another insurance company, Z, under a contract of reinsurance some of the insurance policies that were issued by X to persons other than related insureds. X receives a ceding commission from Z of \$30,000 and thereby increases its gross income other than RPI income by \$30,000. Thus, approximately 15 percent (\$20,000/\$130,000) of X's income is RPI income without regard to the same country exception. At the beginning of the following taxable year, Z reinsures with S, a subsidiary controlled by X, a block of insurance which is similar to the policies X reinsured with Z. W pays Z a ceding commission of \$30,000. Based on the facts and circumstances, X will be

regarded as having engaged in the reinsurance transaction with Z in order to qualify for the de minimus exception. Therefore, the \$30,000 of income from the reinsurance transaction will be ignored in determining whether X qualifies for the de minimus exception.

Example 2. The facts are the same as in *Example 1* in paragraph (b)(2) of this section except that near the end of the taxable year, X enters a reinsurance agreement with M under which X receives \$30,000 in non-RPII premiums. At the beginning of the following taxable year, X cedes to F all of the risks of M that X reinsured at the end of 1986, transferring the \$30,000 in premiums to F. The \$30,000 in non-RPII premiums received by X under the reinsurance agreement will be ignored for purposes of determining whether X qualifies for the de minimus related person insurance income exception.

(2) **Election to treat income as effectively connected.**—(1) *In general.* A controlled foreign corporation, other than a disqualified corporation, may elect in accordance with the procedures set forth in this paragraph to treat its related person insurance income that is not actually effectively connected income under section 864(c) as if it were income effectively connected with the conduct of a trade or business in the United States. To make the election, the foreign corporation must waive all benefits (other than with respect to section 884) with respect to related person insurance income granted by the United States under any treaty, including any friendship, commerce and navigation treaty, between the United States and any foreign country.

(2) **Corporations which may make the election.**—(i) *In general.* The election may be made by any corporation that is not a disqualified corporation. A corporation is a disqualified corporation if, for any taxable year beginning after December 31, 1986, it is a controlled foreign corporation as defined in section 957(a) or (b) (without regard to sections 953(c)(1)(B) and § 1.953-3(b)(2)); for an uninterrupted period of 30 days or more during the taxable year and a United States shareholder, as defined in section 951(b), owns, directly or indirectly, within the meaning of section 958(a) (without regard to the constructive ownership rules of section 958(b)), stock in the corporation at some time during the taxable year.

(ii) **Successor corporation.** A corporation that is a successor to another corporation that, during any taxable year beginning after December 31, 1986, was a disqualified corporation may not make the election. The term "successor corporation" means any foreign corporation that acquires assets of another foreign corporation having a fair market value of 50 percent or more

of the fair market value of all the assets held by the acquired foreign corporation immediately before the acquisition, if 50 percent or more of the combined voting power of all classes of stock entitled to vote or 50 percent or more of the value of all classes of stock in the acquiring corporation is owned, directly or indirectly, at the time of the acquisition by one or more persons who at any time during which the acquired foreign corporation was a disqualified corporation owned, directly or indirectly, 50 percent or more of the combined voting power of all classes of stock entitled to vote or 50 percent or more of the value of all classes of stock in the acquired foreign corporation.

(iii) **Examples.** The following examples illustrate the principles of paragraph (c)(2) of this section.

Example 1. Subsequent to December 31, 1986, 50 domestic corporations, all engaged in business within the same industry, form M, a foreign corporation to insure the risks of the 50 corporations and their subsidiaries. Each of the corporations owns two percent of the one class of voting stock of M outstanding. M may make the election under section 953(c)(3)(C) to have its related person insurance income treated as if it were effectively connected with the conduct of a trade or business within the United States because it has never been a controlled foreign corporation within the meaning of section 957(a) or (b).

Example 2. The facts are the same as in *Example 1* except that four of the 50 domestic corporate shareholders, W, X, Y, and Z, each own 7 percent of the stock of M and are wholly-owned subsidiaries of V, a domestic corporation. None of the other shareholders of M are 10 percent or greater shareholders. M is a controlled foreign corporation under section 957(b) because more than 25 percent of its stock is owned by United States shareholders as defined in section 951(b). Under the attribution rules of section 958(b), W, X, Y, and Z are each considered as owning 28 percent of the stock of M and therefore are United States shareholders under section 951(b) because each is considered as owning the stock of the others by attribution through V. Because each of W, X, Y, and Z own stock in M directly under section 958(a), M is a disqualified corporation.

Example 3. On January 1, 1987, X, a domestic corporation, formed Z under the laws of country F as a reinsurance company constituting a mutual insurance company under the laws of country F. X capitalized Z by contributing interest bearing reserve fund certificates which entitle X to 30 percent of the voting power in Z. Z reinsures policies issued by X, none of which relate to risks located in country F. Under the laws of country F, the policyholders under the policies issued by X and reinsured by Z are members of Z and have voting rights. None of these policyholders hold 10 percent or more of the voting power of Z. However, only those policyholders may receive policyholder

dividends from Z. X is not entitled to any non-liquidating distributions from Z. Z is a controlled foreign corporation within the meaning of section 957(b). Even though neither X nor the United States policyholders have had inclusions of insurance income in their gross income by virtue of subpart F of the Code, because Z is a controlled foreign corporation under section 957(b) it cannot make the election under section 953(c)(3)(C) to have its related person insurance income treated as if it were effectively connected with the conduct of a trade or business within the United States.

(3) **Taxable year of corporation making election.** A corporation making the election to treat related person insurance income as income effectively connected with the conduct of a trade or business in the United States must utilize the calendar year as its annual accounting period for United States tax purposes, as required by section 843.

(4) **Period during which election is in effect.**—(i) **Elections that become effective in taxable years beginning after December 31, 1987.** If an election under paragraph (c)(3) of this section is made for the first taxable year beginning after December 31, 1987 or any subsequent taxable year, the election is effective from the first day of the taxable year for which the election is made (and all subsequent taxable years). Therefore, a foreign corporation that has a fiscal taxable year prior to making the election must file a short-year return for the period from the first day the election becomes effective to the last day of the calendar year in which the election is made.

(ii) **Examples.** The following examples illustrate the rule of paragraph (c)(4)(i) of this section.

Example 1. X is a controlled foreign corporation that keeps its books and records on a calendar year basis. X makes an election under paragraph (c)(3) of this section for the 1988 taxable year. X's election is effective as of January 1, 1988.

Example 2. Y is a controlled foreign corporation that keeps its books and records on a July 1 to June 30 fiscal year basis. Y makes an election under paragraph (c)(3) of this section for the 1988 taxable year. Y's election is effective as of July 1, 1988. Y must file a short-year return covering the period from July 1, 1988 to December 31, 1988.

(iii) **Elections that become effective in first taxable year beginning after December 31, 1986.** For any foreign corporation that makes an election under paragraph (c) of this section for the first taxable year beginning after December 31, 1986, the election is effective as of the date indicated by the corporation on its election statement and for all subsequent taxable years. A foreign corporation that had a fiscal

taxable year prior to making the election must file a short-year return covering the period from the beginning of its 1987 fiscal year to the last day of its 1987 fiscal year. The foreign corporation must include in its gross income for the taxable year in which the election becomes effective the amount of related person insurance income that is attributable to the period from the date the election becomes effective through the last day of the calendar year. The amount of the related person insurance income attributable to such period is that amount determined by allocating to each day in the taxable year its retable portion of related person insurance income. However, if the corporation keeps adequate books and records that, in the district director's discretion, accurately reflect the actual amount of the income earned in such period, the corporation may include such amount in gross income rather than the daily pro rata amount.

(iv) *Examples.* The following examples illustrate the principles of paragraph (c)(4)(iii) of this section.

Example 1. X is a controlled foreign corporation that keeps its books and records on a calendar year basis. X makes an election under paragraph (c) of this section for the 1987 taxable year. In its election statement, X chose September 15, 1987 as the effective date of its election. X must include in gross income the related person insurance income attributable to the period from September 15, 1987 to December 31, 1987 in its calendar year 1987 tax return.

Example 2. Y is a controlled foreign corporation that keeps its books and records on a July 1 to June 30 fiscal year basis. Y makes an election under this paragraph (c) of this section for the 1987 taxable year and chooses to make the election effective as of September 1, 1987. Y must file a short-year return covering the period from July 1, 1987 to August 31, 1987. The related person insurance income of Y that, under Y's method of accounting, is attributable to the period from July 1, 1987 to August 31, 1987 must be included in the gross income of Y's United States shareholders. In addition, X must also file another short-year return covering the period from September 1, 1987 to December 31, 1987 and must include in its gross income for that period the related person insurance income attributable to that period.

(5) *Effect of election: taxation under section 882; alternative minimum tax; dividends received deduction; pre-1987 deficits in earnings and profits; and net operating losses.* If a foreign corporation makes an election under paragraph (c) of this section, all income that is actually effectively connected with the conduct of a trade or business in the United States (as determined under sections 804(c) and 842) and all related person insurance income that is not effectively connected with the conduct

of a trade or business within the United States but is treated as if it were effectively connected by virtue of the election under this paragraph (c) of this section will be taxable under section 882. The branch profits tax imposed by section 804 and the tax imposed on interest described in section 884(f) will apply to an electing corporation to the same extent and in the same manner that those taxes would have applied if the corporation had not made the election. Thus, the exclusion from the branch profits tax contained in section 864(d)(2)(D) (relating to income treated as effectively connected under section 953(c)(3)(C)) does not apply to income which is actually effectively connected with the conduct of a trade or business within the United States under sections 804(c) and 842. Further, a controlled foreign corporation that makes the election under section 953(c)(3)(C) shall continue to be treated as a controlled foreign corporation for purposes of this section 864(c)(4)(D)(ii). Thus, related person insurance income that is treated as income effectively connected with the conduct of a United States trade or business shall not be subject to the branch profits tax under section 804 solely by virtue of making the election under section 953(c)(3)(C). *But see* section 842(b) with respect to the minimum effectively connected net investment income of a foreign corporation conducting an insurance business within the United States. Related person insurance income that is treated as if it were effectively connected with the conduct of a United States trade or business is subject to the alternative minimum tax provisions of sections 55 and 56 of the Code. For purposes of section 245 (dividends from certain foreign corporations), related person insurance income that is treated as if it were effectively connected by virtue of an election under paragraph (c)(3) of this section shall be treated as effectively connected for purposes of determining post-1986 undistributed U.S. earnings under section 245(a)(5). Net operating loss deductions and deficits in earnings and profits of a corporation making the election under paragraph (c)(3) of this section that would be carried over from, or incurred in, taxable years beginning before January 1, 1986 cannot be carried over to, or used in, taxable years beginning after December 31, 1986.

(6) *Exemption from tax imposed by section 4371.* The tax imposed by section 4371 (relating to policies issued or reinsured by foreign insurers) shall not apply to premiums that are subject to the election under paragraph (c) of this section to treat related person

insurance income which is not otherwise effectively connected income under section 804(c) as if it were effectively connected with the conduct of a trade or business within the United States. The exemption from the tax imposed by section 4371 begins after the later of the date of acceptance of the election or the first day of the first taxable year for which the election is made. An election is accepted on the date when the closing agreement has been executed by the taxpayer and the Commissioner. A copy of the election statement that has been stamped as accepted by the Commissioner will serve to place others on notice of the exemption. If an election has an effective date prior to the date on which the election is accepted, any excise taxes that have been paid on any related person insurance income received prior to the acceptance of the election may be refunded to the person who remitted the taxes. *See also* section 4371, which exempts from the excise tax under section 4371 income which is effectively connected with the conduct of a trade or business within the United States.

(7) *Procedures for making election under section 953(c)(3)(C).*—(i) *In general.* In order to make a valid election to treat related person insurance income as income effectively connected with the conduct of a trade or business in the United States, a foreign corporation must provide the Internal Revenue Service with a signed election statement, a signed closing agreement, and a letter of credit.

(ii) *When election must be made.* In order for the election to be effective for a taxable year, an election statement must be filed on or before the due date of the electing corporation's tax return reporting the related person insurance income earned during the taxable year.

(iii) *Election.* An election is made by mailing an original and one copy of an election statement to the Internal Revenue Service, Assistant Commissioner (International), 22 C.C.51 950 L'Enfant Plaza South, SW, Washington, DC 20024. The statement must be signed under penalty of perjury by a responsible corporate officer, within the meaning of section 6062, stating that the statement and accompanying documents are true and complete to the best of the officer's knowledge and belief. A copy of the accepted election statement must be attached to the first tax return of the electing corporation that includes related person insurance income to which the election under paragraph (c) of this section applies. The election

statement must be made in the following (or substantially similar) form:

Foreign Corporate Insurance

Company election Under Section 953(c)(3)(C)

(1) (Name, address, tax identification number (a number will automatically be assigned to those corporations not already having a number), and place of incorporation of the corporation) hereby elects under section 953(c)(3)(C) to treat its related person insurance income, as defined in section 953(c)(2), that is not actually effectively connected with the conduct of a trade or business in the United States under sections 864 or 842, as income effectively connected with the conduct of a trade or business within the United States.

(2) (Name of corporation) waives all benefits (other than with respect to section 894) with respect to related person insurance income under any treaty, including any friendship, commerce and navigation treaty, between the United States and any foreign country.

(3) (Name of corporation) agrees to timely file a United States income tax return and timely remit the income tax due on its related person insurance income, determined as if all such income were effectively connected with the conduct of a United States trade or business.

(4) Attached to this election statement is a complete list of all United States shareholders, as defined in section 953(c)(1)(A), and § 1.953-3(b)(2), which own stock in (Name of corporation) as of a date no more than 90 days prior to the date this election statement is mailed. The list includes the name, address, tax identification number, and ownership percentage for which such United States shareholder. (Name of corporation) agrees to file an updated list containing the information prescribed in this paragraph determined as of the last day of each taxable year. This updated list will be filed with the United States tax return reporting the related person insurance income earned by the corporation for each taxable year the election is in effect. (Attach listing).

(5) (Name of corporation) agrees to file a complete list of all United States persons (whether or not listed as United States persons who own stock in (Name of corporation)) whose risks are insured or reinsured by (Name of corporation), or who have purchased annuities or will receive annuity payments from (Name of corporation) as of the last day of each taxable year. The list will include the name, address, and tax identification number of each United States person so insured or reinsured. The list will be filed with the United States tax return reporting related person insurance income earned by (Name of corporation) for each taxable year the election is in effect.

(6) (Name of corporation) agrees to provide security for the payment of tax due on its related person insurance income. The security will be in an amount and upon the terms as stated in a closing agreement to be executed between the Internal Revenue Service and (Name of corporation).

(7) Attached is the power of attorney, Form 2848, of the person authorized to negotiate a closing agreement on behalf of (Name of corporation).

The undersigned declares under penalty of perjury that the statements contained in this election and accompanying documents are true and complete to the best of his/her knowledge and belief.

Date _____

(Title)

(Name of corporation)

(8) **Closing agreement.** After the receipt of the election statement, the controlled foreign corporation's designated representative will be provided with a model closing agreement and further instructions on completing the election process.

(9) **Letter of credit.**—(i) **In general.** A foreign corporation that makes the election under paragraph (c)(3) of this section must provide a letter of credit issued in favor of the Internal Revenue Service. The letter of credit must generally be in an amount equal to 10 percent of the gross premium income from insuring or reinsuring the risks of United States shareholders and persons related to such shareholders in the 12 month period preceding the filing of the election. In the case of a corporation that did not receive gross premiums from United States shareholders or related persons in the previous 12 month period, the amount of the letter of credit required will be based on an estimate of the projected gross premiums of the corporation for the first year of the election. For purposes of paragraph (c)(9)(i) and (ii) of this section, the term "gross premiums" means the amount of gross premiums written on insurance contracts during the taxable year without adjustment for return premiums, premiums for reinsurance, premiums and other consideration arising out of indemnity reinsurance, or increases in unearned premiums. In all cases, a minimum amount of \$75,000 will be required and the maximum amount required will not exceed \$10,000,000. The foreign corporation must provide, under penalty of perjury, evidence to support the computation of the amount of the letter of credit it proposes as security under paragraph (c) of this section.

(ii) **Changes in the amount of the letter of credit.** Once the amount of the letter of credit has been determined for a taxable year, no change in the amount of the letter of credit is required unless in a subsequent taxable year there is an increase in gross premiums to more than 120 percent of the amount of the gross premiums used to compute the letter of credit (the "base year gross premiums"). If for any taxable year, the foreign

corporation has gross premium income constituting more than 120 percent of the base year gross premiums, the amount of the letter of credit must be increased within 30 days of the filing of the tax return for that year. If a letter of credit in a greater amount must be provided, it must be in the amount of 10 percent of the gross premiums for the taxable year. No changes in the letter of credit is required if gross premiums for a taxable year decline from the base year premium level; however, the taxpayer may submit a new letter of credit equal to 10 percent of the gross premiums for the taxable year in replacement of the outstanding letter of credit.

(10) **Underpayment of tax due.** If it is determined that there is a deficiency or underpayment of any tax due pursuant to the election, the Commissioner will issue a notice of deficiency or notice and demand in the amount of the deficiency or underpayment determined, plus any applicable interest and penalties. Assessment and collection of any deficiency or underpayment of tax will be as provided by the Internal Revenue Code and payment of all additional amounts due will be in accordance with the terms specified in any statement of notice and demand sent to the foreign corporation. If the tax is not paid in accordance with the terms of the statement of notice and demand, collection of the deficiency will be made by resorting to the letter of credit before any levy or proceeding in court for collection is instituted against the controlled foreign corporation or its shareholders. However, nothing in paragraph (c)(3)(10) of this section shall be construed to preclude the Secretary's ability to use the jeopardy assessment procedures of sections 6861 through 6864 of the Code. If the letter of credit is drawn upon, it must be reinstated to the level as provided for under the closing agreement within 90 days after the date drawn upon.

(11) **Termination of revocation of election.**—(i) **Termination.** If a controlled foreign corporation that made the election to treat its related person insurance income as effectively connected income for any taxable year becomes a disqualified corporation, as defined in paragraph (c)(2) of this section, in any subsequent taxable year, the election will not apply to any taxable year beginning after the taxable year in which the corporation becomes a disqualified corporation. If a foreign corporation's election is terminated by virtue of the corporation's becoming a disqualified corporation, the corporation will be barred from making another election under section 953(c)(3)(C).

(ii) *Revocation with consent.* The election to treat related person insurance income as effectively connected with the conduct of a trade or business within the United States can be revoked only with the consent of the Commissioner. In order to obtain a revocation, the taxpayer must request a ruling from the Associate Chief Counsel (International). To determine whether a request for revocation should be granted, consideration will be given to all the facts and circumstances. Among the circumstances that will be considered as favorable to a determination to allow revocation of an election will be whether the foreign corporation would qualify for the de minimis ownership exception of paragraph (a)(1) of this section or the de minimis related person insurance exception of paragraph (b)(2) of this section. If after having made an election under paragraph (c) of this section the foreign corporation makes an election under section 953(d) (relating to the election of a foreign insurance company to be treated as a domestic corporation), the election under this paragraph shall be treated as revoked with the Commissioner's consent beginning with the period that the election under section 953(d) is in effect. The revocation of an election is effective for the taxable year indicated by the Commissioner in the consent. Any foreign corporation that receives the consent of the Commissioner to revoke an election may not make a subsequent election for a period of four years from the end of the first taxable year in which the election is not in effect.

(iii) *Unilateral revocation by Commissioner.* If an electing corporation fails to timely file a return, fails to pay the tax due with respect to related person insurance income that it elects to have taxed as effectively connected income, fails to make the estimated tax payments required by section 6655, or fails to maintain or provide a letter of credit in the appropriate amount, the election may be revoked by the Commissioner for the taxable year in which the electing corporation fails to file a return, pay the tax due, pay the estimated tax, or fails to maintain or provide the appropriate letter of credit or in any subsequent taxable year. If the revocation is made in a taxable year subsequent to the taxable year in which the failure occurs, the Commissioner can make the revocation effective retroactively to the taxable year in which the failure occurred or any subsequent taxable year. Revocation of the election may cause the United States shareholders of the foreign corporation

to be liable for subpart F inclusions and make the foreign corporation liable for the unpaid excise tax on premiums under section 4371 for insurance or reinsurance issued by the foreign corporation. Funds obtained under the letter of credit will be applied to the taxes due from the foreign corporation, its shareholders, or both, with respect to related person insurance income. Any foreign corporation (or successor corporation, as defined in paragraph (c)(2)(ii) of this section) the election of which is unilaterally revoked by the Commissioner shall be barred from making another election under section 953(c)(3)(C).

Par. 4. Section 1.954-1T is amended by revising paragraph (c) to read as follows:

§ 1.954-1T Foreign base company income; taxable years beginning after December 31, 1986 (Temporary).

(c) *Computation of net foreign base company income—(1) General rule.* The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954-1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

- (i) Foreign personal holding company income,
- (ii) Foreign base company sales income,
- (iii) Foreign base company services income,
- (iv) Foreign base company shipping income,
- (v) Foreign base company oil related income, or
- (vi) Full inclusion foreign base company income.

(2) *Computation of net foreign base company income derived from same country insurance income.* Deductions relating to foreign base company income derived from insurance, reinsurance, or annuity contracts covering risks, located in the country in which the controlled foreign corporation is created or organized shall be allocated and

apportioned in accordance with the rules set forth in § 1.953-5.

Par. 5. A new centerheading is added to follow newly designated § 1.953-6A and to precede § 1.960-1:

Regulations Applicable to Taxable Years Beginning After December 31, 1958

Par. 6. Section 1.064-1 is amended by adding the following language to the end of paragraph (c)(5):

§ 1.964-1 Determination of the earnings and profits of a foreign corporation.

(c) *Tax adjustments* . . .

(5) *Controlling United States shareholders.* . . . In the event that a foreign corporation is a controlled foreign corporation solely by virtue of section 953(c)(1)(B), the controlling United States shareholders of the foreign corporation shall be those United States shareholders (as defined in section 953(c)(1)(A)) who, in the aggregate, own (within the meaning of section 958(a)) more than 25 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote. In the event that the foreign corporation is a controlled foreign corporation solely by virtue of section 953(c)(1)(B) but the United States shareholders (as defined in section 953(c)(1)(A)) do not, in the aggregate, own (within the meaning of section 958(a)) more than 25 percent of the total combined voting power of all classes of the stock of such corporation entitled to vote, the controlling shareholders of the foreign corporation shall be all those United States shareholders (within the meaning of section 953(c)(1)(A)) who own (within the meaning of section 958(a)) stock of such corporation.

Par. 7. Section 1.1240-1 is amended by revising paragraph (a)(2) to read as follows:

§ 1.1240-1 Treatment of gain from certain sales or exchanges of stock in certain foreign corporations.

(a) *In general* . . .

(2) In respect of a United States person who sells or exchanges stock in a foreign corporation, the conditions referred to in paragraph (a)(1) of this section are satisfied only if—

(i) Such person owned, within the meaning of section 958(a), or was considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign

corporation at any time during the 5-year period ending on the date of the sale or exchange and during that time the foreign corporation was a controlled foreign corporation as defined in section 957, or

(ii) Such person owned, within the meaning of section 958(a), any stock in the foreign corporation at any time during the 5-year period ending on the date of the sale or exchange and during that time the foreign corporation was a controlled foreign corporation as defined in section 953(c)(1)(B).

Par. 8. Section 1.6046-1 is amended as follows:

1. Paragraph (a)(2)(i) is revised.

2. Paragraph (c)(1)(i) and (c)(1)(ii)(c) is revised.

3. New paragraph (c)(1)(iii) is added preceding the concluding text of paragraph (c)(1).

4. The added and revised provisions read as follows:

§ 1.6046-1 Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, on or after January 1, 1963.

(a) Officers of directors * * *

(2) When liability arises after January 1, 1963—(i) Requirement of return. Each United States citizen or resident who is at any time after January 1, 1963, an officer or director of a foreign corporation shall make a return on Form 5471 setting forth the information described in paragraph (a)(2)(ii) of this section with respect to each United States person who, during the time such citizen or resident is such an officer or director—

(a) Acquires (whether in one or more transactions) outstanding stock of such corporation which has, or which when added to any such stock then owned by him (excluding any stock owned by him on January 1, 1973, if on that date he owned 5 percent or more in value of such stock) has, a value equal to 5 percent or more in value of the outstanding stock of such foreign corporation.

(b) Acquires (whether in one or more transactions) an additional 5 percent or more in value of the outstanding stock of such foreign corporation, or

(c) Is not described in paragraph (a)(2)(i)(a) or (b) of this section, and who, at any time after January 1, 1987, is treated as a United States shareholder under section 953(c) and § 1.953-3(b)(2)(i) with respect to a foreign corporation.

(c) Returns required of United States persons when liability to file arises after January 1, 1953—(1) United States persons required to file. * * *

(i) Such person acquires (whether in one or more transactions) outstanding stock of such foreign corporation which has, or which when added to any such stock then owned by him (excluding any stock owned by him on January 1, 1963, if on that date he owned 5 percent or more in value of such stock) has, a value equal to 5 percent or more in value of the outstanding stock of such foreign corporation.

(ii) * * *
(c) Disposes of sufficient stock in such foreign corporation to reduce his interest to less than 5 percent in value of the outstanding stock of such foreign corporation, or

(iii) Such person is, at any time after January 1, 1987, treated as a United States shareholder under section 953(c) with respect to a foreign corporation.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7803.

Par. 10. Section 602.101(c) is amended by adding the following in the appropriate place in the table:

"§ 1.953-4 . . . 1545-	"
"§ 1.953-5 . . . 1545-	"
"§ 1.953-6 . . . 1545-	"

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26 CFR Parts 1 and 602

(INTL-939-86)

PIN 1545-AJ70

Insurance Income of a Controlled Foreign Corporation for Taxable Years Beginning After December 31, 1986

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of public hearing on proposed regulations.

SUMMARY: This document provides notice of public hearing on proposed regulations relating to the definition and computation of insurance income of a controlled foreign corporation and certain captive insurance companies.

DATES: The public hearing will be held on Monday, June 24, 1991, beginning at 10 a.m. Requests to speak and outlines

of oral comments must be received by Monday, June 10, 1991.

ADDRESSES: The public hearing will be held in the Internal Revenue Service Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. The requests to speak and outlines of oral comments should be submitted to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC-CORP:T.R. (INTL-939-86), room 4429, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Carol Savage of the Regulations Unit, Assistant Chief Counsel (Corporate), 202-343-0232 or 202-566-3935. (not a toll-free number).

SUPPLEMENTARY INFORMATION: The subject of the public hearing is proposed regulations under sections 953, 954, 964, 1248, and 6046 of the Internal Revenue Code of 1986. The proposed regulations appear elsewhere in this issue of the Federal Register.

The rules of § 601.601(a)(3) of the "Statement of Procedural Rules" (26 CFR part 601) shall apply with respect to the public hearing. Persons who have submitted written comments within the time prescribed in the notice of proposed rulemaking and who also desire to present oral comments at the hearing on the proposed regulations should submit not later than Monday, June 10, 1991, an outline of the oral comments/testimony to be presented at the hearing and the time they wish to devote to each subject.

Each speaker (or group of speakers representing a single entity) will be limited to 10 minutes for an oral presentation exclusive of the time consumed by the questions from the panel for the government and answers to these questions.

Because of controlled access restrictions, attendees cannot be permitted beyond the lobby of the Internal Revenue Building until 9:45 a.m.

An agenda showing the scheduling of the speakers will be made after outlines are received from the persons testifying. Copies of the agenda will be available free of charge at the hearing.

By direction of the Commissioner of Internal Revenue.

Dale D. Goode.

Federal Register Liaison Officer, Assistant Chief Counsel (Corporate).

[FR Doc. 91-8694 Filed 4-16-91; 8:45 am]

BILLING CODE 4830-01-0