

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002-68

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88-73, 1988-2 C.B. 383, provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates

used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)-1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for September 2002 is 4.76 percent. Pursuant to Notice 2002-26, 2002-15 I.R.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
October	2002	5.60	5.04 to 6.16	5.04 to 6.72

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Newman may be reached at 1-202-283-9888 (not a toll-free number).

Interest Rates and Appropriate Foreign Loss Payment Patterns for Determining the Qualified Insurance Income of Certain Controlled Corporations Under Section 954(i)

Notice 2002-69

I. PURPOSE

This notice provides interim guidance for determining the interest rates and appropriate foreign loss payment patterns to be used by controlled foreign corporations in

calculating their qualified insurance income under section 954(i) of the Internal Revenue Code. Taxpayers may rely on the guidance in this notice until regulations or other guidance are published.

II. BACKGROUND

In general, a United States shareholder of a controlled foreign corporation ("CFC") must include in gross income its *pro rata* share of the CFC's Subpart F income for each year. I.R.C. Sec. 951(a). Subpart F income includes, among other types of income, foreign base company income. Sec. 952(a). Section 954(a)(1) defines the term "foreign base company income" to include, among other types of income, foreign personal holding company income. Section 954(c)(1) sets forth the types of income (*e.g.*, interest and dividends) that are considered to be foreign personal holding company income. Sec. 954(c)(1)(A).

Section 954(i)(1) provides that for purposes of section 954(c)(1), foreign personal holding company income does not include "qualified insurance income" of a "qualifying insurance company". Section

954(i)(2) defines the term "qualified insurance income" to mean income of a qualifying insurance company falling into either of two categories. First, income received from unrelated persons and derived from investments made by a qualifying insurance company or qualifying insurance company branch (collectively referred to as a "QIC") either of its reserves allocable to exempt contracts or of 80 percent of its unearned premiums from exempt contracts (as both are determined in accordance with section 954(i)(4)). Sec. 954(i)(2)(A). Second, income received from unrelated persons and derived from investments made by a QIC of an amount of its assets allocable to exempt contracts equal to: (1) in the case of property, casualty, or health insurance contracts, one-third of the premiums earned on those contracts during such year; and (2) in the case of life insurance or annuity contracts, 10 percent of the reserves described in section 954(i)(2)(A) for such contracts. Sec. 954(i)(2)(B).

For purposes of determining the first category of qualified insurance income, section 954(i)(4)(A) provides that the unearned premiums and reserves of a QIC with re-

spect to property, casualty, or health insurance contracts shall be determined using the same methods and interest rates that would be used if such QIC were subject to tax under Subchapter L, subject to two modifications, discussed below. Under the general rules of Subchapter L, an insurance company (other than a life insurance company) determines its "discounted unpaid losses" (as defined under section 846), which is a type of insurance reserve, at the end of each taxable year by taking the sum of discounted unpaid losses separately computed with respect to unpaid losses in each line of business attributable to each accident year. Sec. 846(a)(1). The amount of discounted unpaid losses as of the end of any taxable year attributable to any accident year is the present value of such unpaid losses determined by using: (1) the amount of undiscounted unpaid losses; (2) the applicable interest rate; and (3) the applicable loss payment pattern. Sec. 846(a)(2).

For purposes of determining the unearned premiums and reserves of a QIC, section 954(i)(4)(A) makes two modifications to these general Subchapter L rules, as stated above. First, the QIC must use the interest rate determined for the functional currency of a QIC calculated in the same manner as the Federal mid-term rate under section 1274(d), except as provided by the Secretary. Sec. 954(i)(4)(A)(i). Second, the QIC must use the "appropriate foreign loss payment pattern". Sec. 954(i)(4)(A)(ii).

This notice provides rules for computing the discounted unpaid losses of a CFC by applying the general rules of section 846, as modified by section 954(i)(4), when determining: (1) the amount of undiscounted unpaid losses; (2) the applicable interest rate; and (3) the applicable loss payment pattern.

III. UNDISCOUNTED UNPAID LOSSES

A. General Rule

The term "undiscounted unpaid losses" means the unpaid losses shown on the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer. Sec. 846(b)(1). The term "annual statement" means the annual statement approved by the National Association of Insurance Commissioners which the

taxpayer is required to file with the insurance regulatory authorities of the State. Sec. 846(f)(3).

B. Undiscounted Unpaid Losses for a QIC

A QIC does not file an annual statement as defined under section 843(f)(3). As a result, a QIC shall use the undiscounted unpaid losses reflected on the statement or report filed with a foreign regulatory authority. If no statement or report is filed with a foreign regulatory authority, or if the statement or report that is filed does not reflect undiscounted unpaid losses, a QIC shall use the undiscounted unpaid losses used for financial reporting purposes in the United States.

IV. APPLICABLE INTEREST RATE

A. General Rule

The amount of discounted unpaid losses as of the end of any taxable year is the present value of the unpaid losses calculated by using the "applicable interest rate". Sec. 846(a)(2). The applicable interest rate for purposes of section 846 is the average of the applicable Federal mid-term rates (as defined in section 1274(d), but based on annual compounding) effective as of the beginning of each of the calendar months in the test period. Sec. 846(c)(2)(A). The test period is the most recent 60-calendar-month period ending before the beginning of the calendar year for which the determination is made. Sec. 846(c)(1)(B).

A. Applicable Interest Rate For a QIC

Section 954(i)(4)(A) provides that the unearned premiums and reserves of a QIC shall be determined using the same methods and interest rates as if such QIC were subject to Subchapter L, except that the interest rate determined for the functional currency of a QIC, except as provided by the Secretary, is substituted for the applicable Federal interest rate. Accordingly, if the functional currency of a QIC is the U.S. dollar, the applicable interest rate is a 60-month average of the applicable federal mid-term rates published in accordance with Treas. Reg. § 1.1274-4(b) (using annual compounding). If the functional currency of the QIC is a currency other than the U.S. dollar, the applicable interest rate is a 60-month average of the interest rates for the

functional currency of the QIC determined in accordance with Treas. Reg. § 1.1274-4(d) (using annual compounding).

V. APPLICABLE LOSS PAYMENT PATTERN

A. General Rule

Section 846(d)(1) directs the Secretary to determine a loss payment pattern for each line of insurance business for each determination year. Any loss payment pattern determined by the Secretary shall apply to the accident year ending with the determination year and to each of four succeeding accident years. Sec. 846(d)(1). The term "line of business" means a category for the reporting of loss payment patterns determined on the basis of the annual statement for fire and casualty insurance companies for the calendar year ending with or within the taxable year, except that multiple peril lines of business are treated as a single line of business. Sec. 846(f)(4). The term "determination year" means calendar year 1987 and each fifth calendar year thereafter. Sec. 846(d)(4).

Determinations under section 846(d)(1) for any determination year are made by the Secretary: (1) by using the aggregate experience reported on the annual statements of insurance companies; (2) on the basis of the most recently published data from such annual statements relating to loss payment patterns available on the first day of the determination year; (3) as if losses paid or treated as paid during any year were paid during the middle of such year; and (4) in accordance with the computational rules set forth in section 846(d)(3). Sec. 846(d)(2).

Under section 846(e)(1), a taxpayer may elect to use a loss payment pattern for lines of business determined by reference to the taxpayer's loss payment patterns for the most recent calendar year for which an annual statement was filed before the beginning of the determination year. Sec. 846(e)(1). Any determination must be made with the application of the rules of section 846(d)(2)(C) and 846(d)(3). Sec. 846(e)(1). A taxpayer may elect to discount unpaid losses using its own historical loss payment pattern instead of the industry-wide pattern determined by the Secretary if it has one or more eligible lines of business. Treas. Reg. § 1.846-2(a). A taxpayer's election applies to all eligible lines of business. Treas. Reg. § 1.846-2(a). A line of business is an eligible line of business

in a determination year if, on the most recent annual statement filed by the taxpayer before the beginning of that determination year, the taxpayer reports losses and loss expenses for at least the number of accident years for which those losses and loss expenses are required to be reported on an annual statement. Treas. Reg. § 1.846-2(b).

An election is made separately for each determination year. Sec. 846(e)(2)(A). Unless revoked with consent of the Secretary, this election applies to accident years ending with the determination year and to each of the four succeeding accident years. Sec. 846(e)(2)(B). An election is made on the taxpayer's return for the taxable year in which the determination year ends. Sec. 846(e)(2)(C). No election is allowed for any international or reinsurance line of business. Sec. 846(e)(3).

B. Appropriate Foreign Loss Payment Pattern for a QIC

Section 954(i)(4)(A)(ii) states that a QIC shall use the "appropriate foreign loss payment pattern." A QIC may determine the appropriate foreign loss payment patterns for each respective line of insurance business under either of the following two options.

(1) A QIC may elect to use the most recent loss payment patterns for one or more lines of business published by the foreign country provided the Secretary has approved the use of such patterns in a Revenue Ruling or other published guidance. (Hereinafter referred to as Option 1.) Treasury and the Internal Revenue Service invite taxpayers to submit information regarding any existing or subsequently published foreign loss payment pattern so that the Secretary can make a determination and, if appropriate, issue guidance indicating that such foreign loss payment pattern may be used by a QIC under Option 1.

(2) A QIC may elect to use its own loss payment patterns for any lines of business sold by the QIC in a foreign country. (Hereinafter referred to as Option 2.) In general, to make this election, a QIC must have sufficient historical information for a line of business to qualify as an eligible line of business under Treas. Reg. § 1.846-2(b). However, for this purpose a

line of business corresponding to one listed in section 846(d)(3)(A)(ii) may qualify as an eligible line of business if a QIC has historical data for that line of business for at least four years after the accident year.

As stated above, a QIC may make different elections for each separate line of business. Notwithstanding section 846(e)(3), an election may be made for any line of business conducted by a QIC, including any international or nonproportional reinsurance line of business. A QIC that makes an election to apply Option 1 or 2 for a taxable year with respect to a line of business must treat as a determination year for that line of business the accident year with which or during which the taxable year of the election ends. The election applies to the determination year and to each of the four succeeding accident years, unless the election is revoked with consent of the Secretary. If a QIC does not make an election to apply either Option 1 or 2 for one or more lines of business, then the appropriate foreign loss payment pattern for such line or lines of business shall be the applicable loss payment patterns set forth in the tables published by the Secretary under section 846(d).

Except as otherwise provided in section 954(i) and this Notice, section 846 and the regulations promulgated thereunder apply in determining the amount of a QIC's discounted unpaid losses.

Special Rules for Applying Option 2

For purposes of Option 2, the computational rules in section 846(d)(3) shall be followed in determining the appropriate foreign loss payment pattern for an eligible line of business, subject to the following modifications for lines of business corresponding to those listed in section 846(d)(3)(A)(ii). First, the period taken into account under section 846(d)(3)(A)(ii) shall be extended to at least the tenth year after the accident year, but not beyond the 15th year after the accident year. Second, the amount paid in the last year after the accident year for which data are available shall be treated as paid in each subsequent year (or, if lesser, the portion of the unpaid losses not theretofore taken into account shall be treated as being paid). However, if application of the previous sen-

tence results in a payment pattern that ends before the tenth year after the accident year, then the amount of unpaid losses remaining after the years for which loss payment data are available shall be treated as paid equally in each year thereafter, ending in the tenth year after the accident year.

Example 1. A QIC has data for seven years after the accident year (AY+0) for its "private passenger auto liability" line. The percentage of losses paid are 32% for AY+0, 27% for AY+1 (one year after the accident year), 14% for AY+2, 8% for AY+3, 5% for AY+4, 3% for AY+5, 3% for AY+6, and 2% for AY+7. This is an eligible line. The QIC elects Option 2 for this line of business, and extends the payment period to AY+10. The payment percentages for the years AY+8, AY+9, and AY+10 are 2% in each year.

Example 2. Assume the same facts as in *Example 1*, except that the payment percentage for year AY+7 is 3%. In this case, use of 3% for the remaining years would terminate the payment pattern in AY+9. Accordingly, the QIC must treat 1.66% as being paid in years AY+8, AY+9, and AY+10.

Example 3. Assume the same facts as in *Example 1*, except that the payment percentage for year AY+7 is 1%. In this case, the QIC must extend the payment period to AY+14 and use 1% for the remaining years from AY+8 through AY+14.

If a taxpayer elects Option 2 for a line of business for which there are fewer than nine years of historical data after the accident year, then the taxpayer shall determine a new payment pattern using the computational rules of section 846(d)(3), as modified by this notice, for each year after the determination year, until such time that the taxpayer has historical data for nine years after the accident year.

Example 4. Assume the same facts as in *Example 1*. The taxpayer has elected Option 2 for this line of business, but has data in the determination year for only seven years after the accident year. Accordingly, the taxpayer must determine a new payment pattern for the accident year immediately following the determination year using updated information for the accident year plus eight years after the accident year. The taxpayer must also determine a new payment pattern for the second accident year following the determination year using updated information for the accident year plus nine years after the accident year. This last payment pattern shall apply to the last three accident years for which the 5-year election to use Option 2 is applicable.

VI. MANNER FOR MAKING ELECTION

Controlling U.S. shareholders shall make the elections referred to in this notice on behalf of a QIC by applying the rules of Treas. Reg. § 1.964-1(c)(3).

VII. EFFECTIVE DATE RULES

Regulations to be issued under section 954(i) concerning the issues addressed in this notice will be effective for taxable years beginning on or after the date such regulations are published as final in the Federal Register. Until such regulations are issued, controlling shareholders of a QIC may rely on this notice to determine the interest rates and appropriate foreign loss payment patterns of a QIC for purposes of section 954(i). Controlling U.S. shareholders also may apply the guidance in this notice to prior taxable years.

VIII. PAPERWORK REDUCTION ACT

The collections of information contained in the notice have been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1799.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this notice are in section V headed Applicable Loss Payment Patterns. This information is required by the IRS to determine whether a QIC is allowed to determine its income by using its own payment pattern data for a particular line of business. The information will be used on examination to determine whether a QIC is calculating its foreign loss payment patterns correctly. The likely respondents are U.S. shareholders that own foreign insurance companies.

The estimated total annual reporting burden is 300 hours.

The estimated average annual burden per respondent is 1 hour.

The estimated number of respondents is 300.

The estimated annual frequency of responses is once.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

IX. REQUEST FOR COMMENTS AND DRAFTING INFORMATION

The IRS and Treasury request comments on the rules described in this notice and on the additional issues, if any, that should be addressed when regulations under section 954(i) are issued. Written comments may be submitted to the Associate Chief Counsel (International), Attention: Steven Jensen (Notice 2002-69), Room 4562, CC:INTL:Br5, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC 20224. Alternatively, taxpayers may submit comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. Comments will be available for public inspection and copying. Treasury and the IRS request comments by March 28, 2003. For further information regarding this notice, contact Steven Jensen of the Office of Associate Chief Counsel (International) at 202-622-3870 (not a toll-free call).

Rev. Proc. 2002-67

Settlement of Section 351 Contingent Liability Tax Shelter Cases

SECTION 1. PURPOSE

.01 This revenue procedure prescribes procedures for Taxpayers who elect to participate in a settlement initiative aimed at resolving cases involving Contingent Liability Transactions that are the same as or substantially similar to those described in Notice 2001-17, 2001-1 C.B. 730 ("Contingent Liability Transactions").

.02 This revenue procedure provides for two resolution methodologies. The first option is a Fixed Concession Procedure set forth in Section 5. The second option is a Fast Track Dispute Resolution Procedure — Contingent Liability Cases set forth in Section 6; this second method includes the Binding Arbitration Procedure set forth in Section 7. The basic eligibility requirements for both options are set forth in Section 3. Additional eligibility requirements for the Fixed Concession Procedure are set forth in Section 5.01.

.03 Both resolution methodologies are designed to ensure that any tax benefits associated with the Contingent Liability Transactions are claimed no more than once, in

the aggregate, by the Taxpayer or an entity that was a member of the Taxpayer's consolidated group (including any successor to such group) at any time. Any ambiguity in this revenue procedure should be resolved in favor of achieving this purpose.

.04 Both resolution methodologies are also designed to provide flexibility to accommodate a large variety of views on the relative merits of the case. The Arbitration Procedure is intended to require each party to realistically assess the merits of the case and achieve a resolution in the event of irreconcilable differences before a neutral expert who must choose between the divergent settlement proposals without modification. Maximum flexibility, within the stated range of concession, is provided for the negotiations. This resolution should provide strong incentives to resolve disputes with quick, competent review and certainty of repose at a reduced cost for both parties.

SECTION 2. BACKGROUND

.01 The transactions in question generally involve a transfer that purportedly complies with section 351 of the Internal Revenue Code of high basis, high value assets from a transferor corporation ("Taxpayer") to a transferee corporation controlled by the transferor. The assets are transferred in exchange for stock of the transferee corporation and the transferee's assumption of a liability of the transferor, which has not yet been taken into account for tax purposes. The Taxpayer takes the position that the basis of the stock of the transferee corporation received by the transferor is equal to the bases in the assets transferred, without a reduction in basis for the liability assumed. The transferor subsequently sells the stock at a reported capital loss equivalent to the present value of the assumed liability. When the liability ultimately is taken into account for tax purposes, the transferee claims the tax benefits associated with the liability.

.02 The Commissioner of the Internal Revenue Service and Treasury have designated these transactions as "listed transactions" for purposes of Temp. Treas. Reg. § 1.6011-4T(b)(2) in Notice 2001-17.

