2003 Insurance Tax Year in Review: Part IV -- International Tax Issues

by Diana Chapman, Jim Cohen, Mary Gillmarten, and Richard Safranek

In the final installment of a four-part report, practitioners from Deloitte & Touche's Tax Practice group discuss some of the relevant international tax developments affecting the insurance industry in 2003.

Date: Feb. 26, 2004

2003 Insurance Tax Year in Review: Part IV -- International Tax Issues

by Richard Safranek, Mary Gillmarten, Jim Cohen, and Diana Chapman

Introduction

[1] The Treasury Department and the IRS published a good volume of domestic guidance during 2003 for the insurance industry, but relatively little guidance for international insurance operations. The published international guidance, although not voluminous, was nonetheless significant and included modifications to section 953(d) elections, new procedures for obtaining treaty excise tax exemption closing agreements, and two letter rulings that allow foreign reserve calculations to be used in computing subpart F income.

Legislation

ETI Replacement Legislation

[2] **Citations:** S. 1637, the Jumpstart Our Business Strength Act of 2003 (S. Rept. 108-192) (Nov. 7, 2003). For the full text, see *Doc 2003-24262 (378 original pages)* [**PDF**] or *2003 TNT 218-19*. H.R. 2896, the American Jobs Creation Act of 2003 (H. Rept. No. 108-393) (July 25, 2003). For the full text see *Doc 2003-25263 (255 original pages)* [**PDF**] or *2003 TNT 227-15*.

[3] **Discussion:** As discussed in Part I -- Federal Tax Matters, both the House Ways and Means and Senate Finance Committees have approved separate bills to repeal the extraterritorial income tax (ETI) and replace it with domestic and international tax reforms.

[4] In addition to repealing the ETI, the Finance Committee bill, the Jumpstart Our Business Strength (JOBS) Act (S. 1637), would reduce the tax rate on income from U.S. domestic manufacturing by approximately 3 percentage points (from the current 35 percent) over five years. It also includes a proposal to reduce the tax rate on repatriated foreign income to 5.25 percent for the first tax year of an electing taxpayer ending more than 120 days after enactment. The provisions require that the dividends be reinvested according to a dividend reinvestment plan to qualify for the reduced rate.

[5] International tax reforms in the JOBS Act include proposals to:

- Modify the interest expense allocation rules, effective for tax years beginning after December 31, 2008;
- Extend the foreign tax credit carryforward period to 20 years, enabling excess foreign taxes to be carried to any taxable year after date of enactment;
- Recharacterize overall domestic losses, effective for tax years beginning after December 31, 2006;
- Repeal the 90 percent limitation on the use of foreign tax credits against the alternative minimum tax (AMT), effective for tax years beginning after December 31, 2004;
- Provide look-through treatment for payments between related controlled foreign corporations (CFCs) under foreign personal holding company (FPHC) rules, effective for tax years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end; and
- Expand the subpart F *de minimis* rule to the lesser of 5 percent of gross income or $5 million, effective for tax years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.

[6] The Ways and Means Committee bill, the American Jobs Creation Act of 2003 (H.R. 2896), would phase out present-law ETI tax incentives over three years, lower the corporate income tax rate for income from domestic manufacturing to 32 percent by 2007, and provide international tax reform. The Ways and Means bill shares many of the JOBS Act's international reform proposals but also adds proposals to:

- Establish look-through treatment for sales of partnership interests, effective for tax years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end;
- Repeal the foreign personal holding company rules and foreign investment company rules, effective for tax years of foreign corporations beginning after December 31, 2006, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end;
- Expand the subpart F exemption for active financing income by liberalizing the requirement that an eligible CFC conduct substantial business activity by allowing activities performed by employees of related persons to qualify under certain circumstances, effective for tax years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end;
- Reduce the number of foreign tax credit baskets to two, effective for tax years beginning after December 31, 2004.
- Treat the European Community as one country for purposes of the subpart F foreign base company sales and services rules (but not for purposes of calculating exempt insurance income under section 953).

[7] As noted in the discussion of federal tax issues above, when Congress ended the 2003 legislative session, neither bill had been voted on in its respective chamber. Because of political pressures being exerted by the European Union, however, Congress is likely to address ETI repeal earlier in 2004 than generally would be the case with tax legislation.

Foreign Operations of U.S. Taxpayers

New Procedures for Section 953(d) Election

[8] **Citations:** Rev. Proc. 2003-47; 2003-28 IRB 55 (June 20, 2003). For the full text, see *The Insurance Tax Review*, August 2003, p. 317; *Doc 2003-15049 (6 original pages)* [**PDF**]; or *2003 TNT 120-8*.

[9] **Overview:** This revenue procedure updates existing procedural guidance for making an election under section 953(d).

[10] **Discussion:** Rev. Proc. 2003-47 provides new procedural rules for foreign insurance companies electing under section 953(d) to be treated as domestic corporations for U.S. tax purposes. The revenue procedure, which modifies and supersedes Notice 89-79 1989-2 C.B. 392 provides new procedures for satisfying the office and assets test, including procedures for taking into account the office and assets of a U.S. affiliate. The revenue procedure requires that the electing corporation or its U.S. affiliate provide a calculation showing that the asset test requirements are met. The IRS has also provided a new mailing address for elections and replaced Form 2848-D with Form 8821 to designate an authorized representative to receive confidential tax information on behalf of the corporation making the election. The new procedures are welcome because they clarify and formalize practices that had been adopted informally under Notice 89-79.

IRS Warns Against Using Offshore Insurance Companies to Avoid Tax

[11] **Citations:** Notice 2003-34; 2003-23 IRB 990 (May 9, 2003). For the full text, see *The Insurance Tax Review*, June 2003, p. 965; *Doc 2003-11699 (7 original pages)* [**PDF**]; or *2003 TNT 91-49*. Notice 2003-35; 2003-23 IRB 992 (May 9, 2003). For the full text see *The Insurance Tax Review*, June 2003, p. 968; *Doc 2003-11700 (2 original pages)* [**PDF**]; or *2003 TNT 91-50*.

[12] **Overview:** The IRS issued a notice warning individuals against using investments in purported offshore insurance companies to defer recognition of ordinary income or to characterize the income as capital gain.

[13] **Discussion:** Notice 2003-34 reiterates that to qualify for the active insurance company exception to the passive foreign investment company (PFIC) rules, a company must qualify as an insurance company for federal tax purposes. The notice does not represent new guidance for making that determination, but it does suggest that something more than insurance company status may be necessary to satisfy the "active" requirement of the PFIC exception. In this connection, please refer to an article Deloitte published several years ago when a similar concern surfaced within the IRS tracking the PFIC insurance company exception to provisions requiring only that the company qualify as an insurance company.[1]

[14] Notice 2003-35, released on the same day as Notice 2003- 34, dealt with a similar issue as to whether certain organizations that purport to be tax exempt under section 501(c)(15) should be respected as insurance companies. This notice is discussed in the product tax article above.

Substantial Compliance With QEF Election

[15] **Citations:** LTR 200327026 (Mar. 24, 2003). For the full text, see *Doc 2003-15916 (5 original pages)* [**PDF**] or *2003 TNT 129-40* .

[16] **Overview:** This letter ruling held that a domestic limited partnership may treat PFICs in which it owns an interest as qualified electing funds (QEFs) based on the doctrine of substantial compliance, despite the partnership's failure to properly make the elections.

[17] **Discussion:** The IRS considered the following factors in allowing the QEF election: whether the taxpayer's failure to comply defeats the purpose of the statute, whether the taxpayer is attempting to benefit from hindsight by adopting a position inconsistent with its original action or omission, whether the Service is prejudiced by the untimely election, whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default, and whether the regulation provided with detailed specificity the manner in which an election was to be made.

Foreign Insurance Companies Permitted to Use Data Prepared for Local Regulatory Purposes in Determining Subpart F Income

[18] **Citations:** LTR 200327052 (Jan. 21, 2003). For the full text, see *The Insurance Tax Review*, August 2003, p. 329; *Doc 2003-15942 (10 original pages)* [**PDF**]; or *2003 TNT 129-37* . LTR 200341019 (July 8, 2003). For the full text, see *The Insurance Tax Review*, December 2003, p. 940; *Doc 2003-22269 (11 original pages)* [**PDF**]; or *2003 TNT 198-20* .

[19] **Overview:** In two separate letter rulings, the IRS allowed taxpayers to use foreign statement reserves filed with local insurance regulatory agencies in computing subpart F income for U.S. federal tax purposes.

[20] **Discussion:** Subpart F income normally is computed based on U.S. tax concepts, but Congress recognized that this can in certain cases cause income to be subject to subpart F inclusion that should more properly be eligible for deferral. Congress authorized the IRS to accept foreign reserves in certain cases either through the private ruling process or by issuing general guidance. During 2003, the IRS for the first time exercised this authority. In LTR 200327052, two CFCs were regulated as insurance companies by government agencies in the country in which they operate. An insurance company CFC's income includes foreign personal holding company income, reduced by appropriate income on assets backing certain reserves. Local regulatory law required the CFCs to hold certain underwriting reserves, loss reserves, and policyholder dividend share reserves computed using the methodologies and actuarial standards prescribed by the local insurance regulatory agency. Section 954(i)(4)(B)(i) provides in general that in the case of a life insurance and annuity contract, a qualifying insurance company's reserves allocable to exempt contracts are equal to the greater of (1) the net surrender value of the contract or (2) the reserve determined under the principles of subchapter L (section 954(i)(5)) with certain modifications. Section 954(i)(4)(B)(ii), however, provides that a CFC may use foreign statement reserves to compute subpart F income if the taxpayer receives permission from the IRS through a private letter ruling or published guidance. To date, the IRS has not published any guidance. The taxpayer received approval in the private letter ruling that the factors taken into account in determining the foreign statement reserves provided an appropriate means of measuring income for federal tax purposes. The IRS ruled that the taxpayer could use the foreign statement reserves filed with the local insurance regulatory agency in computing subpart F income for U.S. federal tax purposes. In so ruling, the IRS noted that the reserve held was less than the amount of such reserve

computed on the net level premium methodology normally required in setting such reserves.

[21] In LTR 200341019, the CFC was also regulated by a foreign insurance regulator that required the CFC to meet requirements relating to minimum capital, licensing, product standards, management of insurers, asset management, insurance accounting including the calculation of reserves, the sale and solicitation of insurance contracts, and other actuarial matters. As in LTR 200327052, the IRS ruled that the taxpayer could use the foreign statement reserves filed with the local insurance regulatory agency in computing subpart F income for U.S. federal tax purposes. The IRS based its ruling on the fact that the CFC's insurance reserves were fully reported on the financial statements filed with the appropriate governmental regulatory agencies in the foreign country and that the CFC complied with all local insurance laws and regulations. The IRS noted that certain of the reserves in question were calculated according to the net level premium method, and that the reserves in question were not catastrophe, deficiency, equalization, or similar reserves.

[22] In the absence of more generally applicable guidance, each taxpayer is required to seek its own private letter ruling to use foreign statement reserves. This may not be the best way to proceed on a long-term basis, so it may be hoped that generally applicable guidance will be forthcoming in due course as the IRS becomes more comfortable with the rules in specific jurisdictions.

Worthless Stock Loss Allowed in Check-the-Box Transaction

[23] **Citations:** Rev. Rul. 2003-125; 2003-52 IRB 1243 (Dec. 9, 2003). For the full text, see *Doc 2003-26114 (5 original pages)* [**PDF**] or *2003 TNT 237-16*.

[24] **Overview:** In Rev. Rul. 2003-125, the IRS held that a check-the-box liquidation was an identifiable event that fixes the loss on the worthlessness of a subsidiary's stock.

[25] **Discussion:** The ruling is based in large part on Rev. Rul. 70-489, 1970-2 C.B. 53, which held that when a wholly owned subsidiary had bona fide indebtedness to its parent that exceeded the fair market value of its assets and the subsidiary transferred all of its assets to the parent in partial satisfaction of its indebtedness, the parent could claim both a bad debt deduction and a worthless security deduction, even though the parent continued the business formerly conducted by the subsidiary. Rev. Rul. 2003-125 also demonstrates the IRS's reversal from its previous position that a check-the-box liquidation was not an identifiable event for worthlessness.

U.S. Operations of Foreign Insurance Companies

Service Issues Federal Excise Tax Exemptions

[26] **Citations:** LTR 200348001 (Aug. 28, 2003). For the full text, see *Doc 2003-25401 (5 original pages)* [**PDF**] or *2003 TNT 230-48*.

- LTR 200344012 (July 30, 2003). For the full text, see *The Insurance Tax Review*, December 2003, p. 945; *Doc 2003- 23542 (4 original pages)* [**PDF**]; or *2003 TNT 212-35*.
- LTR 200330039 (Apr. 28, 2003). For the full text, see *Doc 2003-17479 (4 original pages)* [**PDF**] or *2003 TNT 145-6*.

- LTR 200330035 (Apr. 28, 2003). For the full text, see *Doc 2003-17475 (9 original pages)* [**PDF**] or *2003 TNT 144-67*.
- LTR 200330031 (Apr. 23, 2003). For the full text, see *Doc 2003-17471 (4 original pages)* [**PDF**] or *2003 TNT 144-66*.
- LTR 200327047 (Apr. 2, 2003). For the full text, see *Doc 2003-15937 (8 original pages)* [**PDF**] or *2003 TNT 129-66*.
- LTR 200332008 (Feb. 27, 2003). For the full text, see *Doc 2003-18348 (3 original pages)* [**PDF**] or *2003 TNT 154-33*.
- LTR 200323016 (Feb. 21, 2003). For the full text, see *Doc 2003-13816 (4 original pages)* [**PDF**] or *2003 TNT 110-45*.
- LTR 200321013 (Feb. 18, 2003). For the full text, see *Doc 2003-12743 (14 original pages)* [**PDF**] or *2003 TNT 101-32*.

[27] **Overview:** The IRS in 2003 issued nine private letter rulings with excise tax closing agreements. Seven of the nine were for companies resident in Ireland, one for a company resident in Sweden, and one for a company resident in Switzerland. As we have noted in previous years, as the corporate tax rate in Ireland decreases, more companies are being established in Ireland as non- International Financial Services Centre companies that can benefit from the excise tax exemption in the U.S.-Ireland treaty. Ireland has grown as a financial center in Europe and the fact that it also provides access to the European Union market is a significant factor in making it a venue of choice for new insurance companies.

[28] **Discussion:** The seven rulings issued to Irish insurers and reinsurers were virtually identical. In each ruling, the taxpayer relied on Article 23(3)(a) of the U.S.-Ireland Income Tax Treaty, which permits an Irish company to claim excise tax relief and other benefits under the treaty if the company is resident in Ireland and engaged in the active conduct of a trade or business, and the income in question is connected with the trade or business. The protocol to the treaty specifically provides that "an insurance company will be considered to be engaged in the active conduct of a trade or business if its gross income consists primarily of insurance or reinsurance premiums and investment income attributable to such premiums." This language allows resident companies in Ireland to satisfy the active trade or business requirement without having to satisfy the three-prong active trade or business safe harbor test or the 11-factor facts-and-circumstances test found in Rev. Proc. 92-39 1992-1 C.B. 860, which was issued when the U.S.-Germany treaty was adopted.

[29] The eighth ruling (LTR 200327047) involves a German reinsurer of U.S. risks. The ruling applies the safe harbor ratio test found in Rev. Proc. 92-39 for qualification under the active trade or business test. The ratio safe harbor test provides that a foreign insurer or reinsurer is considered to derive premium income in connection with the active conduct of a trade or business in Germany if for the company's preceding taxable year the average of three ratio tests (assets, premiums, and payroll and commission expenses) is satisfied. The German reinsurer satisfied the ratio tests and was eligible for treaty benefits. (Note: Rev. Proc. 92-39 was superseded by Rev. Proc. 2003-78 -- see below.)

[30] The ninth ruling (LTR 200332008), involving a Swiss reinsurer, applies the derivative benefits test in the limitation on benefits article in the U.S.-Switzerland treaty. The derivative benefits test allows a Swiss resident to qualify for treaty benefits if the ultimate beneficial owners of the company would be entitled to treaty benefits. In this instance, the ultimate beneficial owners were U.S. individuals and the Swiss reinsurer was eligible for treaty benefits.

[31] The most significant action taken by the IRS with respect to excise tax exemption rulings is the announcement that it will not issue formal rulings in the future due to the new procedures under Rev. Proc. 2003-78 (see discussion below).

IRS Issues New Procedures for Treaty-Based Excise Tax Exemptions

[32] **Citations:** Rev. Proc. 2003-78; 2003-45 IRB 1029 (Oct. 10, 2003). For the full text, see *The Insurance Tax Review*, December 2003, p. 925; *Doc 2003-22323 (11 original pages)* [**PDF**]; or *2003 TNT 198-7* .

[33] **Overview:** In Rev. Proc. 2003-78, the IRS provided new procedures for entering into a closing agreement that establishes an exemption from Internal Revenue Code section 4371 excise taxes on premiums paid to foreign insurers or reinsurers under the provisions of a U.S. tax treaty.

[34] **Discussion:** Rev. Proc. 2003-78, which supersedes Rev. Proc. 92-39, simplifies the procedure for entering into an excise tax closing agreement with the IRS, and broadens application of the procedure to all foreign insurers and reinsurers that are resident in treaty partner jurisdictions when the treaty contains an excise tax exemption provision. A person otherwise required to remit the insurance excise tax on account of premiums paid to a foreign insurance or reinsurance company may consider the premiums exempt from the insurance excise tax under an income tax treaty if, before filing the return for the taxable period, the person has knowledge that there was in effect for such taxable period a closing agreement between the IRS and the foreign insurer or reinsurer.

[35] Under section 3.04 of Rev. Proc. 2003-78, a foreign insurer or reinsurer that wishes to enter into a closing agreement must submit the following documentation:

- A statement signed under penalties of perjury that the foreign insurer or reinsurer is a treaty resident and qualifies for benefits under the limitation on benefits article of the pertinent treaty;
- A letter of credit in the amount of $75,000;
- A Form SS-4, Application for Employer Identification Number (EIN), for applicants that do not have an EIN; and
- A list of position titles of those persons who will be the parties responsible for performance under the closing agreement, including the names, addresses, and telephone numbers of those persons as of the date the application is submitted.

[36] Rev. Proc. 2003-78 streamlines and standardizes the process for obtaining the insurance excise tax exemption for all residents of countries that have entered into treaties with the U.S. that contain provisions for the exemption of the insurance excise tax. A formal ruling request is no longer needed, although the IRS still requires a payment of $6,000.

[37] The now superseded Rev. Proc. 92-39 required that the foreign insurer or reinsurer obtain a certificate of foreign residence from the local tax authority. This requirement has been abandoned and replaced with a Penalties of Perjury Statement attesting to the foreign residence of the insurer or reinsurer.

[38] Rev. Proc. 2003-78 retains the requirement that foreign insurers or reinsurers obtain a

letter of credit in the amount of $75,000 in favor of the IRS as security for payment of tax. However, the letter of credit must now be submitted with the request for a closing agreement rather than at the time of signature. The letter of credit must be issued by a U.S. bank or by a U.S. branch or agency of a foreign bank that is on the National Association of Insurance Commissioners' list of banks from which letters of credit may be accepted.

[39] As mentioned above, no future excise tax exemption rulings will be published because a formal ruling is no longer contemplated under the new procedure. It might be expected that several United Kingdom (U.K.) insurance companies will be making such filings as the new treaty takes effect, so a streamlined procedure is likely to prove quite helpful.

Foreign Life Insurance Company: Effectively Connected Income

[40] **Citations:** Rev. Rul. 2003-17; 2003-6 IRB 400 (Jan. 23, 2003). For the full text, see *The Insurance Tax Review*, March 2003, p. 414; *Doc 2003-2177 (4 original pages)* [**PDF**]; or *2003 TNT 16-4* .

[41] **Overview:** The IRS ruled that a foreign life insurance company could not exclusively rely on the annual statement submitted to the state insurance commissioner (NAIC Statement) when determining the amount of income that is effectively connected (ECI) with its U.S. business. While the ruling provides that the NAIC Statement will be given due regard, a foreign insurance company also must take into account non-trusteed assets that are connected with its U.S. branch when calculating its income pursuant to section 864(c).

[42] **Discussion:** In this ruling, a foreign life insurance company (FC) had a U.S. branch in State Y. FC sold life insurance policies to U.S. persons through its U.S. branch. Pursuant to the laws of State Y, FC trusteed required assets and filed an NAIC Statement with the state insurance commissioner. The NAIC Statement identified as U.S. taxable investment income only that income derived from its trusteed assets. FC also maintained non-trusteed assets in the U.S. and included these assets on the books of the U.S. branch, but FC did not report these assets on its NAIC Statement. In determining the amount of its ECI, FC relied exclusively on the NAIC Statement, thereby excluding from U.S. taxable income all income related to the non-trusteed assets.

[43] This practice was consistent with the historical computation of taxable income by domestic insurers and with the legislative history of section 864(c), which provides that the NAIC Statement will usually be followed in determining whether or not income of a foreign insurance company is effectively connected with the conduct of its U.S. business. However, in Rev. Rul. 2003-17, while the IRS acknowledged this legislative history, it emphasized that the legislative history also provides that section 864(c) shall determine whether income is ECI. In the IRS's view, because section 864(c) does not contain specific language as to what constitutes ECI with respect to foreign insurance companies, income from non-trusteed assets that are managed by individuals in the U.S. and accounted for on the books of the U.S. branch are not necessarily excluded from ECI merely because they do not appear on the NAIC Statement.

Foreign Bank: Effectively Connected Income

[44] **Citations:** *National Westminster Bank Plc. v. U.S.*, 58 Fed. Cl. 491 (Nov. 14, 2003). For the full text, see *Doc 2003-24845 (35 original pages)* [**PDF**] or *2003 TNT 223-9* .

[45] **Overview:** The taxpayer, a U.K. bank, contended successfully that the formula for allocating interest expense to its U.S. branch under Treas. Reg. 1.882-5 was inconsistent with the separate entity principles of Article 7 of the U.K.-U.S. tax treaty.

[46] **Discussion:** Relying in large part on *Northwest Life Assurance Company of Canada v. Commissioner*, 107 T.C. 363 (1996), which held that the formulary methodology for attributing investment income to a U.S. branch of a Canadian life insurance company under section 842 (b) violated the separate entity principles of the Canada-U.S. Tax Treaty, the U.S. Court of Federal Claims held in *National Westminster Bank, Plc. v. U.S.* that the formulary methodology for allocating interest expense under Treas. Reg. 1.882-5 violated the similar provisions of the 1975 U.K.-U.S. tax treaty. Although quite important in its own right, the holding in *National Westminster* is perhaps most relevant to non-U.S. insurance companies because it provides added comfort to companies relying on the holding in *Northwest Life*.

Treaties

U.S.-U.K. Income Tax Treaty Enters in Force With Anti-Conduit Provisions Applying to Excise Tax Exemption

[47] **Discussion:** The U.S.-U.K. income tax treaty and a related protocol entered into force on March 31, 2003, with an exchange of instruments of ratification between the U.S. and the U.K. The new treaty's anti-conduit rule now applies to the excise tax exemption. The previous treaty did not require satisfaction of the anti-conduit provisions with respect to free excise tax exemption. The government has not provided guidance with respect to the anti- conduit rule. Rev. Proc. 2003-78 (discussed above) provides a separate form closing agreement for the U.S.-U.K. treaty and other similar treaties that may have anti-conduit provisions. IRS sources have told us that several U.K. excise tax exemption closing agreement requests have been filed under Rev. Proc. 2003-78.

New Protocols Enter Into Force, Negotiations Begin on Other Protocols

[48] **Discussion:** The protocol to the Australia-U.S. income tax treaty entered into force on May 12, 2003. The protocol provides for a zero percent withholding on dividends. The Treasury Department also announced that it has begun negotiating a new protocol with Canada.

[49] The competent authorities of both the Netherlands and the U.S. have entered into a mutual agreement to clarify the entitlement of exempt pension funds to benefits under the 1992 U.S.-Netherlands income tax treaty. Dutch officials also hope to negotiate a new protocol eliminating withholding tax on dividends.

Clarification of Ownership Requirements Under the U.S.-Swiss Treaty

[50] **Discussion:** The competent authorities of the U.S. and Switzerland entered into a competent authority agreement concerning the ownership requirements under the U.S.-Swiss treaty's limitation on benefits rules. Under the agreement, a resident may satisfy the limitation on benefits requirement if more than 70 percent of the aggregate vote and value of its shares is ultimately owned by persons that are residents of a party to the North American Free Trade Agreement (NAFTA), and that are also described in Article 22(3)(b). Under Article 22(3)(b), ultimate beneficial ownership by a resident of a country that is a party to NAFTA will be taken

into account for purposes of Article 22(3)(a)(ii) and paragraph 7 of the Memorandum of Understanding only if the ultimate beneficial owner meets certain conditions.

Barbados-United States Treaty Negotiations

[51] **Discussion:** Treasury announced in Press Release JS- 945 (Oct. 27, 2003) that tax treaty negotiators from the U.S. and Barbados met to discuss revisions to the current income tax treaty. Among the stated aims of the discussions are ensuring relief from double taxation for cross-border trade and investment and preventing tax evasion.

Japan-United States Agree to New Tax Treaty

[52] **Discussion:** The U.S. and Japan signed a new proposed treaty and protocol on November 6, 2003, which is expected to be ratified this year and will enter into force in 2005. The new protocol eliminates the excise tax on insurance premiums in cases where the risk is not reinsured with persons not entitled to the benefits of a U.S. treaty that exempts such premiums from the tax. Other noteworthy provisions in the treaty are:

- A complete exemption from taxes on royalties (Article 12);
- A qualified exemption from taxes on certain intercompany dividends (Article 10);
- Branch profits tax limitations (Article 10);
- New transfer pricing provisions (Article 9);
- No "ultimate owner" concept in the limitation on benefits provisions applicable to indirect subsidiaries of publicly traded companies (Article 22);
- Elimination of the independent personal services article (Article 7);
- Inclusion of an "Other Income" article (Article 21);
- Limitation on Benefits (Article 22); and
- Special provisions concerning Japanese *Tokumei Kumiai* entities (Protocol paragraph 13).

Miscellaneous Developments

IRS and Treasury Clarify the Definition of Qualified Foreign Corporations Under the Jobs and Growth Act

[53] **Citations:** Notice 2003-69; 2003-42 IRB 851 (Sep. 30, 2003). For the full text, see *Doc 2003-21501 (3 original pages)* [**PDF**] or *2003 TNT 190-17*. Notice 2003-71; 2003-43 IRB 922 (Oct. 3, 2003). For the full text, see *Doc 2003-21859 (3 original pages)* [**PDF**] or *2003 TNT 193-13*. Notice 2003-79; 2003-50 IRB 1206 (Nov. 26, 2003). For the full text, see *Doc 2003-25438 (11 original pages)* [**PDF**] or *2003 TNT 229-2*.

[54] **Overview:** Since the enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003, the IRS and Treasury have issued several notices clarifying qualified foreign corporation status and reporting obligations.

[55] **Discussion:** The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum rate of tax to 15 percent on certain dividends paid to individual shareholders. The reduced rate applies to dividends received from domestic corporations and "qualified foreign corporations." The Act provides that a foreign corporation can qualify as a "qualified foreign corporation" under any of the following three tests: (1) the foreign corporation is incorporated in

a possession of the U.S. (the "possessions test"); (2) the foreign corporation is eligible for the benefits of a comprehensive income tax treaty (the "treaty test"); or (3) the stock of the foreign corporation with respect to which such dividend is paid is readily tradable on an established securities market in the U.S. (the "readily tradable test"). Notice 2003-69 provides a list of countries whose income tax treaties in force with the U.S. satisfy the requirements of the treaty test under the Act. Notice 2003-71 provides that common stock satisfies the readily tradable test if it is listed on a national stock exchange. Notice 2003-79 provides simplified procedures in connection with the reporting of foreign qualified dividends on Form 1099-DIV, Dividends and Distributions.

Non-U.S. Developments

U.K. Inland Revenue Loses in the First Round of Largest Tax Case in U.K. History

[56] **Discussion:** In the U.K., if a resident company paid a dividend, it also had to pay advance corporation tax (ACT) to the Inland Revenue. The rate of ACT varied, but at the relevant time was 25 percent of the dividend. However, if the dividend-paying company was a subsidiary of a U.K. holding company, the two companies could make a joint election under section 247 of the Income and Corporation Taxes Act 1988, the effect of which was that the paying company did not have to pay ACT after all. If the dividend-paying company was a subsidiary of a non-U.K. holding company, this election was not available. In the *Metallgesellschaft* case, the European Court of Justice (ECJ) held that if the non-U.K. holding company was established in another member state (Germany, in that case), the denial of the right of election to it and its subsidiary was contrary to the freedom of establishment conferred by article 52 (now article 43) of the EU Treaty. Further, the ECJ held that for ACT paid in the past by U.K. subsidiaries of parent companies in other member states, EU law conferred a right to compensation or restitution that the aggrieved companies were entitled to pursue in the U.K. courts. In response to the ECJ decision, many U.K. subsidiaries of parents domiciled in other member states claimed relief in the U.K. courts for ACT. Many claims have been consolidated under a group litigation order with several chosen as test cases to determine the various issues.

Conclusion

[57] The coming year promises to be a very active one in the international tax arena. Legislatively, there may well be further action on ETI repeal. On the regulatory front, the IRS Associate Chief Counsel, International, has publicly stated that the Service is prioritizing guidance on mergers and acquisitions, transfer pricing, dual consolidated losses, and foreign dividend tax relief for 2004. The IRS has also said that it plans to work on foreign tax credit simplification and possibly provide new PFIC guidance.

FOOTNOTE

[1]*See* Richard Safranek and Diana Chapman, "Restrictive Regs May Threaten Insurance Company Exception to the PFIC Rules," *Ins. Tax. Rev.*, July 1997, p. 1147.

END OF FOOTNOTE


Comment on this story

Tax Analysts Information

Code Section: Section 801 -- Life Insurance Company Tax
Geographic Identifier: United States
Subject Area: Insurance company taxation
Industry Group: Insurance
Author: Chapman, Diana; Cohen, Jim; Gillmarten, Mary; Safranek, Richard
Institutional Author: Deloitte & Touche
Tax Analysts Document Number: Doc 2004-623 (7 original pages) [PDF]
Tax Analysts Electronic Citation: 2004 TNT 38-62