Section 842.—Foreign Companies Carrying on Insurance Business

26 CFR 1.864–4(c): U.S. source income effectively connected with U.S. business.
(Also section 864(c).)

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ISSUE

Whether a foreign life insurance company carrying on an insurance business in the United States determines the amount of income effectively connected with its U.S. business under section 842(a) of the Internal Revenue Code (the "Code") based exclusively on the amount of income reported by the business on the National Association of Insurance Commissioner's annual statement ("NAIC statement") filed with the state insurance commissioner.

FACTS

FC, a Country X corporation, is a foreign life insurance company that issues life insurance, annuity, and other insurance contracts in Country X and the United States. FC's activities in connection with its insurance business constitute the conduct of a trade or business within the United States (the "U.S. branch"). FC conducts its insurance activities in State Y. Under the law of State Y, FC is required to maintain trusteed assets and deposits in the United States sufficient to satisfy all potential claims of its U.S. policyholders. FC also maintains in the United States and uses in its U.S. business non-trusteed assets consisting of bonds, stocks, and short-term investments which are managed by individuals located in the United States and accounted for on the books of the U.S. branch.

FC is required to file a NAIC statement with State Y. Generally, this NAIC statement is intended to permit the insurance regulatory body to determine whether a foreign insurance company has sufficient assets to satisfy all potential claims of its U.S. policyholders. While the trusteed assets held by FC (and corresponding income) are required to be included on the NAIC statement, the non-trusteed assets (and corresponding income) are not reflected in the NAIC statement.

LAW AND ANALYSIS

Section 842(a) provides that if a foreign company carrying on an insurance business within the United States would qualify under part I of subchapter L for the taxable year if (without regard to income not effectively connected with the conduct of any trade or business within the United States) it were a domestic corporation, such company shall be taxable under such part on its income effectively connected with its conduct of any trade or business within the United States. Section 842(a) further provides that with respect to the remainder of income which is from sources within the United States, such a foreign company shall be taxable as provided in section 881.

Section 864(c)(1) provides that in the case of a foreign corporation engaged in a trade or business within the United States during the taxable year, the rules set forth in section 864(c)(2), (3), (4), (6), and (7) shall apply in determining the income, gain or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States ("ECI"). Section 864(c)(2) generally provides rules for determining whether certain fixed or determinable, annual or periodical income from sources within the United States or gain or loss from sources within the United States from sale or exchange of capital assets is ECI. In making this determination, the factors taken into account include whether (a) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or (b) the activities of such trade or business were a material factor in the realization of such income, gain or loss. Sec. 864(c)(2). Treas. Reg. § 1.864–4(c)(2) sets forth factors to be considered in determining whether an asset is used in or held for use in the conduct of a U.S. trade or business for purposes of section 864(c)(2). Under the regulations, an asset is ordinarily treated as used in, or held for use in, the conduct of a U.S. trade or business if the asset is: (a) held for the principal purpose of promoting the present conduct of the U.S. trade or business; (b) acquired and held in the ordinary course of the U.S. trade or business; or (c) otherwise held in a direct relationship to the U.S. trade or business. Treas. Reg. § 1.864–4(c)(2)(ii). In determining whether an asset is held in a direct relationship to the U.S. trade or business, principal consideration is given to whether the asset is held to meet the present needs of the business. Treas. Reg. § 1.864–4(c)(2)(iv)(a). An asset shall be considered as needed in the U.S. business if, for example, the asset is held to meet the operating expenses of that business, but not if held for future diversification into a new trade or business, expansion of trade or business activities outside the United States, or future business contingencies. *Id.* The regulations provide for a presumption of a direct relationship where: (1) the asset was acquired with funds generated by the trade or business; (2) the income from the asset is retained or reinvested in the trade or business; and (3) personnel present in the United States and actively involved in the conduct of that trade or business exercise significant management and control over the investment of the asset. Treas. Reg. § 1.864–4(c)(2)(iv)(b).

In determining whether an asset is used in or held for use in the conduct of a U.S. trade or business or whether the activities of the trade or business were a material factor in the realization of the income, gain or loss, due regard is given to whether or not such asset, or income, gain or loss was accounted for through the trade or business. Sec. 864(c)(2); Treas. Reg. § 1.864–4(c)(4). However, this accounting test shall not by itself be controlling. Treas. Reg. § 1.864–4(c)(4).

All other income, gain or loss from sources within the United States is treated as ECI. Sec. 864(c)(3). Section 864(c)(4)(C) provides that in the case of a foreign insurance company any income from sources without the U.S. which is attributable to its U.S. business is treated as ECI. *See also*

Treas. Reg. § 1.864–5(c) (In determining its life insurance company taxable income from its U.S. business, the foreign corporation shall include all of its items of income from sources without the United States which would appropriately be taken into account in determining the life insurance company taxable income of a domestic corporation).

The Report of the House Committee on Ways & Means (the "House Report") provides:

> Your committee believes that foreign insurance companies—life insurance companies and other insurance companies, including both mutual and stock companies—should, in general, be taxed on their investment income in the same manner as other foreign corporations. For this reason, the bill provides that a foreign insurance corporation carrying on an insurance business within the United States is to be taxable in the same manner as domestic companies carrying on a similar business with respect to its income which is effectively connected with the conduct of a trade or business within the United States. . . . For purposes of determining whether or not income of a foreign life insurance company is effectively connected with the conduct of its U.S. life insurance business, the annual statement of its U.S. business on the form approved by the National Association of Insurance Commissioners will *usually* be followed. It is noted that *all* the income effectively connected with the foreign life insurance company's U.S. life insurance business, from whatever source derived, comes within the ambit of this provision. This is a continuation of present law which subjects to U.S. tax all the income attributable to the U.S. life insurance business from whatever source derived.

H.R. Rep. No. 1450, 89th Cong., 2d Sess. 31, 32 (1966) (emphasis added); S. Rep. No. 1707, 89th Cong., 2d Sess. 38 (1966) (same).

The House Report also states that "[i]n determining for purposes of subchapter L whether a foreign corporation is carrying on an insurance business in the United States, and whether income is effectively connected with the conduct of a trade or business within the United States, section 864(b) and (c), as added by section 2(d) of the bill, shall apply." House Report at 94. Thus, the legislative history confirms that a foreign life insurance company applies the standards set forth in section 864(c) to determine the amount of its effectively connected income.

Accordingly, under section 842(a) and consistent with the accompanying legislative history, foreign insurance companies are taxed on their ECI. Section 864(c) does not contain specific rules for foreign insurance companies other than in section 864(c)(4)(C). Similarly, no specific rules were provided for foreign insurance companies in regulations issued under section 864 other than Treas. Reg. § 1.864–5(c). Neither section 842 or 864 provides that an insurance company determines its ECI solely based on its NAIC statements.

While the legislative history states that NAIC statements will *usually* be followed, the legislative history makes clear that section 864(c) shall determine whether income is ECI. Accordingly, income on assets such as the non-trusteed assets of FC are not necessarily excluded from ECI merely because they do not appear on the NAIC statement.

Section 864(c)(2) and the regulations thereunder provide that due regard shall be given to whether or not an asset, income, gain, or loss was accounted for through the U.S. trade or business. Accordingly, in determining if the income, gain or loss from the non-trusteed assets is ECI, due regard must be given to the fact that FC has accounted for such assets on the books of the U.S. branch.

HOLDING(S)

FC is taxable on any income effectively connected with its U.S. trade or business. For this purpose, ECI is determined under section 864(c) and the accompanying regulations. While due regard shall be given to the NAIC statement, such statement shall not be determinative of the amount of ECI. Further, due regard also must be given to the fact that FC has accounted for the non-trusteed assets on the books of the U.S. branch.

DRAFTING INFORMATION

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