PROPOSED P.F.I.C. EXCEPTION REGULATIONS DETRIMENTAL TO FOREIGN INSURERS

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The I.R.S. issued proposed regulations (REG-108214-15) for the Exception from Passive Income for Certain Foreign Insurance Companies on April 24, 2015. The goal of the proposed regulations is to prevent hedge funds from establishing foreign insurance companies to defer and reduce tax that would otherwise be due with respect to investment income. The foreign insurance companies may be passive foreign investment companies ("P.F.I.C.'s"). The I.R.S. invited the public to comment on all aspects of the proposed rules by July 23, 2015. According to the comments released, many industry professionals deem these regulations as too restrictive on insurance companies and claim the rules needlessly subject legitimate insurance businesses to the harsh tax treatment of P.F.I.C.'s.

According to the preamble, Prop. Reg. §1.1297-4 is designed to "provide guidance regarding when a foreign insurance company's income is excluded from the definition of passive income under section 1297(b)(2)(B)," which affects the U.S. shareholders of foreign corporations and policyholders.[1] The proposed regulations re-define the terms "active conduct" and "insurance business" in addition to how passive income is determined.

The main critiques reflected in the comments by insurance industry representatives are that the limited definition of "active conduct" will prevent foreign insurance companies from qualifying for the exception and that the rules disregard industry practices with respect to how investment activities and administrative services are performed by actual insurance companies. Overall, the comments express that the implementation of the proposed regulations would severely limit which foreign companies can qualify as insurance businesses and would result in harsh P.F.I.C. treatment for legitimate insurance companies.

HEDGE FUND REINSURANCE ARRANGEMENTS

The proposed regulations target hedge funds that take advantage of the P.F.I.C. exception carved out for foreign insurance companies in Code §1297(b)(2)(B) to exclude their income from passive investment treatment. Hedge funds are typically organized as flow-through entities that generate short-term capital gains, which are subject to the high ordinary income tax rates. Over the years, hedge funds have re-characterized their income from passive to active by purporting to be foreign reinsurance companies. These arrangements have allowed the investors to defer recognition of income and to characterize ordinary income as a capital gain. By entering into these reinsurance arrangements, hedge funds have been able to defer tax on what is actually investment income that should be taxed under the P.F.I.C. regime.[2]

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1. Exception From Passive Income for Certain Foreign Insurance Companies, 80 Fed. Reg. 22954 (Apr. 24, 2015) (amending 26 C.F.R. pt. 1).
2. Notice 2003-34, 2003-23 I.R.B. 990 (May 9, 2003).

According to Notice 2003-34,[3] which addresses the issue of hedge fund reinsurance agreements, a typical arrangement involves an investor or "Stakeholder, subject to U.S. income taxation, investing (directly or indirectly) in the equity of an enterprise ('F.C.'), usually a corporation organized outside the United States." The F.C. is compliant with local insurance laws, and issues "insurance or annuity contracts" or contracts to "reinsure" risks underwritten by insurance companies, but the F.C.'s insurance activities are "relatively small compared to its investment activities." Since the F.C. is regarded as an insurance company engaged in the active conduct of an insurance business, the investors do not recognize the company as a P.F.I.C. Thus, "when [a] Stakeholder disposes of its interest in F.C., it will recognize gain as a capital gain, rather than as ordinary income."[4]

The Treasury and I.R.S. are concerned about the company being characterized as an insurance company when in fact the income is passive investment income that should be taxed under the P.F.I.C. regime. Notice 2003-34 states that it will apply the P.F.I.C. rules where it determines that a foreign corporation is not an insurance company for federal tax purposes. In order to combat these offshore hedge fund reinsurance arrangements, the proposed regulations under §1.1297-4 were issued.

"INSURANCE COMPANY" UNDER THE CODE

A corporation is subject to tax as an insurance company under subchapter L[5] only if *more than half* of its business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

The term "insurance company" was not defined in the Code until 1984. Prior to its debut in the Code, an insurance company was defined in Treas. Reg. §1.801-3(a) as a company whose *primary and predominant* business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The prevailing regulatory definition of insurance company was enacted into the Code in 1984 in §816(a), and subsequently, Code §831(c) changed the definition of "insurance company" to any company with *more than half* of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. The two prevailing Code sections implement a stricter standard of "more than half" of the business instead of the prior regulatory law's "primary and predominant" standard.[6]

P.F.I.C. RULES UNDER CODE §1297

Code §1297 provides that a foreign corporation is a P.F.I.C. if it meets either the passive income test or the passive asset test. Under the passive income test enumerated in Code §1297(a)(1), a foreign corporation is a P.F.I.C. if 75% or more of its gross income for the taxable year is passive income. Under the passive asset test enumerated in Code §1297(a)(2), a foreign corporation is a P.F.I.C. when on average 50% or more of its assets produce passive income or are held for the production

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3 *Id.*

4 *Id.*

5 Subchapter L of the Code pertains to the tax treatment of insurance companies.

6 Preamble to REG-108214-15, 80 F.R. 22954 (April 24, 2015).

of passive income. "Passive income" is generally defined in Code §1297(b)(1) to mean any income of a kind that would be "foreign personal holding company income" as defined in Code §954(c), which is typically investment-type income not derived from the active conduct of a trade or business. Thus, a passive asset generally generates (or is reasonably expected to generate in the reasonably foreseeable future) passive income.

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INSURANCE BUSINESS EXEMPTION FROM P.F.I.C. TREATMENT

Code §1297(b)(2) provides certain exceptions to the term "passive income." Under Code §1297(b)(2)(B), passive income does not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. However, the terms "active conduct" and "insurance business" are not defined in Code §1297, which is why the I.R.S. issued the proposed regulations in April 2015.

According to the preamble to the proposed regulations:

> [The] Treasury and the I.R.S. are proposing regulations to clarify the circumstances under which investment income earned by a foreign insurance company is derived in the active conduct of an insurance business for purposes of determining whether the income is passive income, and thus the extent to which the company's assets are treated as passive assets for purposes of determining whether the company is a P.F.I.C.[7]

PROP. REG. §1.1297-4 EXCEPTION FROM THE DEFINITION OF PASSIVE INCOME FOR CERTAIN FOREIGN INSURANCE COMPANY INCOME

Prop. Reg. §1.1297-4(a) establishes that for purposes of Code §1297, the term "passive income" does not include income earned by a foreign corporation that would be taxed as an insurance company under subchapter L if it were a domestic corporation, but only to the extent the income is derived in the active conduct of an insurance business.

The term "active conduct" is defined in Prop. Reg. §1.1297-4(b)(1) to have the same meaning as in Treas. Reg. §1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities.

The term "insurance business" is defined in Prop. Reg. §1.1297-4(b)(2) to mean the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are required to support or are substantially related to insurance contracts issued or reinsured by the foreign insurance corporation.

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[7] *Id.*

Prop. Reg. §1.1297-4(b)(2) establishes a two-part test for determining whether an activity is an "investment activity," which reflects the passive income test and passive asset test of determining P.F.I.C. status under Code §1297:

> (i) An investment activity is any activity engaged in by the foreign corporation to produce income of a kind that would be foreign personal holding company income as defined in Code §954(c) [Prop. Reg. §1.1297-4(b)(2)(i)] [*i.e.*, generally passive income or income not derived from the active conduct of a trade or business]; and
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> (ii) Investment activities are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts.[8]

The proposed regulations do not address the issue of whether a company is "predominantly engaged" in the insurance business. Since the term "active conduct" of insurance companies uses the Treas. Reg. §1.367(a)-2T(b)(3) without considering officers and employees of related entities, each insurance company must have its own central managers that cannot be shared amongst its related companies. The proposed regulations also mirror the definition of investment activity with regard to the P.F.I.C. passive income and passive asset tests established in Code §1297(a).

COMMENTS

PwC's Comments

PricewaterhouseCoopers Tax Services Limited ("PwC") commented on the proposed regulations "on behalf of a group of midsize, non-publically traded insurers and reinsurers domiciled in Bermuda." A focus of this critique was how the term "active conduct" excludes officers and employees, which is very problematic for insurance businesses that share employees amongst related companies in order to operate practically and efficiently. Preventing related companies from centralizing management in this way is a disadvantage to foreign insurers not economical, and it unfairly establishes harsher treatment for foreign companies than for domestic companies. Furthermore, PwC comments that the rules should focus on the foreign insurers' "activities and contracts, rather than on the employment status of the service providers who carried out these activities."

In its comment letter to the I.R.S. regarding the proposed regulations, PwC expresses its main concerns as follows:

> In summary, PricewaterhouseCoopers Tax Services Limited believes if these regulations were adopted as proposed, excluding the activities of independent contractors and related party service providers in determining whether a foreign insurance company conducted an active insurance business would:

[8] Prop. Reg. §1.1297-4(b)(2)(i).

1. Ignore the established business practices of the (re)insurance industry, particularly small insurance and reinsurance companies and captive (re)insurance companies;

2. Disqualify legitimate companies that otherwise meet the requirements to qualify for the exception under section 1297(b)(2)(B);

3. Force the restructuring of business operations in Bermuda and other offshore domiciles, which in turn would increase the cost of operations and the cost of insurance and reinsurance to U.S. policyholders; and

4. Apply a different standard to domestic and foreign insurers, which would be both protectionist and inconsistent with existing tax law.

Advantage Insurance's Comments

Advantage Insurance Holdings Ltd. ("Advantage Insurance"), an insurance company based in the Cayman Islands, also commented on the proposed regulations. Advantage Insurance focused on (i) holding company structures; (ii) capital requirements for the different types of insurance business; and (iii) application of percentage tests to small or specialty insurance companies. Advantage Insurance identifies itself as a "small multi-line insurance company with the majority of its operations located outside of the United States." The comment letter by the company is generally concerned with the implications of the anti-deferral regimes on small insurance companies.

Advantage Insurance suggested the following, regarding holding company structures and a safe harbor rule:

> Allow for a family of insurance and non-insurance companies under common ownership and control to be evaluated for PFIC status under a common ownership holding company structure using consolidated financial statements prepared in accordance with U.S. GAAP for the ultimate parent company. The holding company group should not be restricted or effectively prohibited from sharing employees or utilizing intracompany management agreements freely among its subsidiaries, and that activities of the holding company and other non-insurance subsidiaries incidental and supportive of the insurance business, such as administrative, financial and investment activities not be restricted for PFIC status purposes.

Advantage Insurance suggested the following regarding capital requirements for different types of insurance businesses:

> If a percentage measurement is utilized to determine if an insurance company holds capital in excess of the reasonable needs of the business, individual threshold amounts should be established for life, health, property, casualty, liability, surety, financial guarantee and other sectors of the insurance industry, with further specificity for primary insurance and reinsurance lines of business. In addition,

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> for an individual company writing multiple lines of business, each line should be measured with its own appropriate percentage and capital allocation. Finally, any percentage applied should take into account the total gross amount of insurance risks written, without regard to the existence or collectability of reinsurance.

Lastly, Advantage Insurance provided a recommendation for how the percentage tests of total assets should be applied considering small or specialty insurance companies:

> If any percentage thresholds are included in the new rules, either (a) apply a minimum dollar amount of capital and surplus over which the percentages apply; or (b) allow for alternate methods of excess capital determination including actuarial studies, scientific risk modeling, ratings agency evaluations, regulatory requirements and industry norms; or (c) both (a) and (b).

CONCLUSION

Overall, the comments to the proposed regulations are critical of the definitions of the terms “active conduct,” “insurance business,” and “passive income” as they relate to foreign insurance companies. The limited definitions hurt legitimate insurance businesses by treating them as P.F.I.C.’s. Furthermore, the proposed regulations fail to address a central issue of whether an insurance company is “predominantly engaged” in the insurance business. Although the I.R.S. intended to prevent hedge funds from taking advantage of the P.F.I.C. exception by operating through foreign insurance companies, the proposed regulations appear to cause unintended and detrimental tax consequences to legitimate offshore insurance businesses.