Passive Foreign Investment Companies

IRS and Treasury Department Issue Proposed Regulations Regarding the Treatment of Insurance Companies Under the “Passive Foreign Investment Company” Rules

SUMMARY

On April 23, 2015, the IRS and Treasury Department released proposed Treasury Regulations (the "Proposed Regulations") affecting insurance companies under the “passive foreign investment company” ("PFIC") rules of the Internal Revenue Code (the “Code”). The Proposed Regulations come in the wake of recent attention in the press and inquiries from Senator Ron Wyden regarding foreign insurance companies organized by or otherwise associated with hedge funds that manage all or a substantial portion of the insurance companies' investment assets. These arrangements have been portrayed as tax avoidance schemes. The Proposed Regulations, however, are not explicitly limited to hedge fund-linked insurance companies and could impact more traditional “offshore” insurance companies.

There are two principal features of the Proposed Regulations. First, the Proposed Regulations provide that a foreign insurance company is generally not engaged in the “active conduct” of an insurance business (which includes both underwriting and investment activities) unless it conducts substantial managerial and operational functions through its own employees and not through employees of independent contractors (or even employees of affiliates). Second, the Proposed Regulations provide that investment income is not earned in an “insurance business” unless that income is earned from assets held by the foreign corporation to meet obligations under the insurance company’s insurance, annuity or reinsurance contracts. The Proposed Regulations do not specify a test for determining whether an asset is held to meet insurance-related obligations, but the preamble to the Proposed Regulations suggests that assets that exceed a specified percentage of the corporation’s total insurance liabilities could be treated as not so held. The preamble then solicits comments on what an appropriate specified percentage might be.
BACKGROUND

A. THE PFIC RULES AND INSURANCE COMPANIES

U.S. owners of PFICs are subject to special rules under the Code. In general, the PFIC rules are intended to require U.S. owners of a PFIC either to: (i) currently include their share of the PFIC’s earnings in income or (ii) treat all gain recognized with respect to the PFIC stock as ordinary income, and pay a deferral charge when their PFIC stock is disposed of (or when the shareholder otherwise receives an “excess distribution”). A foreign corporation is generally treated as a PFIC if either: (i) 75% or more of its income is “passive” income or (ii) 50% or more of its assets are treated as “passive assets” (that is, assets held for the production of passive income).

Insurance companies often earn substantial amounts of dividends and interest, types of income that are generally treated as “passive” for PFIC purposes. However, under a special exception for insurance companies (the “Insurance Exception”), income that would otherwise be considered “passive” is treated as “active” income if it is derived in the active conduct of an insurance business by a corporation which:

- is predominantly engaged in the insurance business; and
- would be subject to tax under “subchapter L” of the Code (the provisions of the Code applicable to U.S. insurance companies) if it were a domestic corporation.

With the exception of the Proposed Regulations, there is very limited authority interpreting the Insurance Exception. The legislative history of this exception observes that Congress intended for insurance companies to be treated as earning “passive” income to the extent they maintain financial reserves in excess of the “reasonable needs” of their insurance businesses. There are, however, no restrictions on the type of insurance income that can be earned by a foreign corporation qualifying for the Insurance Exception.

B. HEDGE FUND INSURANCE COMPANIES

In 2003, the IRS issued a notice (the “Notice”) expressing concern that “in some cases,” hedge funds were using purported insurance arrangements to inappropriately defer income recognition (and to convert ordinary income into capital gain). These arrangements were described in the Notice as follows: first, a U.S. taxpayer would organize (or otherwise invest in) a foreign entity that was licensed and regulated as an insurance company. Then, the insurance company would write contracts that were denominated as “insurance,” “annuity” or “reinsurance” contracts, and invest its capital and

1 See generally Sections 1291 through 1298.
2 Section 1297(a).
3 See Sections 1297(b)(1) and 954(c)(1)(A).
4 See Section 1297(b)(2)(B).
premiums in either hedge funds or assets in which hedge funds typically invest. Although the insurance company’s actual underwriting activities may have been quite limited (and the company may have generated investment income that potentially exceeded the needs of the insurance company’s business), U.S. taxpayers would take the position that the insurance company satisfied the Insurance Exception and therefore was not a PFIC. In the Notice, the IRS—while recognizing that the insurance business inherently involves substantial investment activities—indicated that it intended to challenge such structures “in appropriate cases” on the basis that the hedge fund insurance company is not an “insurance company” for U.S. federal income tax purposes.

More recently, there has been renewed Congressional and administrative interest in arrangements similar to those described above. For example, Representative David Camp’s February 2014 tax reform proposal included a provision that would have limited the Insurance Exception to income derived in the active conduct of an insurance business by a corporation (1) more than 50% of the gross receipts of which for the taxable year consist of premiums; (2) that would be subject to tax under “subchapter L” of the Code if it were a domestic corporation; and (3) the applicable insurance liabilities of which constitute more than 35% of its total assets as reported on the company’s applicable financial statement for the year. In June 2014, Senator Ron Wyden sent a letter to Treasury Secretary Jacob Lew requesting that, among other things, the Treasury Department outline the enforcement activities it had taken against hedge fund-connected reinsurance companies. The letter was followed by a report from the Joint Committee on Taxation, published on July 30, 2014, on hedge fund reinsurance arrangements. After several letters were exchanged between the Treasury Department and Senator Wyden, on February 3, 2015, IRS Commissioner John Koskinen committed to delivering guidance on hedge fund reinsurance arrangements within 90 days.

DISCUSSION

A. THE PROPOSED REGULATIONS

1. General Rule

The Proposed Regulations provide that, under the PFIC rules, the term “passive income” does not include income earned by a foreign corporation that would be subject to tax under “subchapter L” of the Internal Revenue Code (i.e., as an insurance company) if it were a domestic corporation, but only to the extent the income is derived in the active conduct of an insurance business (each of which is separately defined in the Proposed Regulations).  

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8 See Joint Committee on Taxation, Background and Data with Respect to Hedge Fund Reinsurance Arrangements (Jul. 30, 2014).
10 No reference is made in the Proposed Regulations to the statutory requirement that a foreign corporation be “predominantly engaged” in the insurance business. This is because, as explained (footnote continued)
2. “Active Conduct”

The term “active conduct” is defined in the Proposed Regulations as generally having the same meaning as in Treasury Regulations Section 1.367(a)-2T(b)(3), which provides that whether a trade or business is actively conducted “must be determined under all the facts and circumstances” and that “[i]n general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial or operational activities”. However, while Treasury Regulations Section 1.367(a)-2T(b)(3) allows certain employees of a related entity to be treated as employees of the corporation conducting a trade or business, the Proposed Regulations provide that, for purposes of the Insurance Exception, officers and employees of a related entity cannot be considered officers and employees of an insurance company.

3. “Insurance Business”

An “insurance business” is defined, under the Proposed Regulations, as the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation. For this purpose, under the Proposed Regulations, an “investment activity” is any activity engaged in by a foreign corporation to produce income (including dividends, interest and many forms of capital gain) that would be “foreign personal holding company income” under the “subpart F” rules of the Code.11

In addition, the Proposed Regulations provide that “investment activities” are required to support (or are substantially related to) insurance and annuity contracts issued or reinsured to the extent that the “income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts”. The Proposed Regulations do not prescribe a methodology for determining the extent to which assets are held to meet obligations under insurance and annuity contracts. However, the preamble to the Proposed Regulations suggests that assets might be held to support insurance-related obligations to the extent that they do not exceed a specified percentage of the corporation’s total insurance liabilities for the year.12

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11 See Section 954(c).
12 The preamble to the Proposed Regulations also indicates that a corporation’s total insurance liabilities for a year might, for example, be defined as the sum of the corporation’s “total reserves” (as defined in Section 816(c) of the Code) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of Section 807(c) of the Code (generally amounts necessary to satisfy insurance or annuity obligations, certain advance premiums and other special reserves).
The IRS and Treasury Department are soliciting comments on “all aspects of” the Proposed Regulations. Specific comments have been requested, however, on both: (i) the percentage of a foreign corporation’s total insurance liabilities that might be an appropriate limit for determining whether investments are held to support insurance obligations and (ii) other methodologies for associating assets with insurance obligations that might be more appropriate than a “percentage of total insurance liabilities” approach. The deadline for submitting comments on the Proposed Regulations is July 23, 2015 (90 days after the Proposed Regulations were published in the Federal Register).

The Proposed Regulations are proposed to take effect on the date when they are published as final regulations in the Federal Register.

B. IMPACT AND QUESTIONS

The Proposed Regulations were issued in response to Congressional concerns that certain hedge funds may be interpreting the Insurance Exception too broadly. It is not clear, however, whether the Proposed Regulations are intended to apply solely to hedge fund-linked insurance companies (and perhaps other insurance companies that undertake what the IRS and Treasury Department view as excessive investment activity, making them—in substance—more like investment vehicles than insurance companies), or whether the Proposed Regulations are intended to have a broader impact. Unless the Proposed Regulations are clarified, it is possible that they could affect—in addition to hedge fund insurance companies—more traditional “offshore” reinsurers of U.S. and third-country risk.

At a more granular level, a significant ambiguity in the Proposed Regulations is how much (and what types of) activity a foreign insurance company must undertake through its own employees to be considered to be in the “active conduct” of an “insurance business”. As noted above, an “insurance business” (which must be “actively conducted” through the insurance company’s own employees) is defined in the Proposed Regulations as “the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation”.

This requirement can be interpreted in at least two ways. One possibility is that the IRS and Treasury Department believe that the Insurance Exception should apply only if an insurance company conducts both substantial investment and underwriting activities (and perhaps administration) through its own officers and employees. Traditional offshore insurance companies—which typically have employees but outsource significant aspects of their underwriting and investment to third-party service providers or affiliates—may find it difficult to satisfy the Insurance Exception under this interpretation.

Alternatively, it may be that the IRS and Treasury Department intend for the “active conduct” requirement to limit the Insurance Exception to foreign insurance companies that conduct at least some significant insurance-related activity (which could perhaps consist of investment, underwriting, or a combination of the two) through their own employees. Put differently, it may be that the IRS and
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Treasury Department intend for the “active conduct” requirement to disqualify insurance companies that employ “turn-key” service providers (and effectively conduct no activity of their own, other than to rely on investment advice from a hedge fund or its employees), but to have no effect on other insurance companies. While this may seem to be a more reasonable interpretation of the Proposed Regulations, it should be noted that a hedge fund-linked insurance company may well be able to satisfy such an “active conduct” test. Regardless of the interpretation given this clause, more traditional offshore insurance companies that operate through multiple subsidiaries and affiliates may have to examine their operations to confirm whether the employees conducting insurance activities are actually employed by the relevant insurance companies.

A more explicit ambiguity in the Proposed Regulations is how one would determine whether income is “earned from assets held by the foreign corporation to meet obligations under the contracts”. In previous correspondence to Senator Wyden, the Treasury Department recognized that factors specific to a particular insurance company—such as the level of reserves required by the regulator in the insurance company’s domicile, the nature of the insured risks and the volatility of the insurance company’s investments—may be relevant to this determination. The preamble to the Proposed Regulations, however, seems to suggest that the IRS and Treasury Department may be contemplating a fixed, specified percentage of the corporation’s total insurance liabilities that is not adjusted in response to factors specific to the particular insurance company being tested. As noted above, the IRS and Treasury Department are seeking input from the industry regarding how such a test might be formulated.

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