Tax Insights
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Senator Wyden introduces The Offshore Reinsurance Tax Fairness Act to amend the PFIC exception for foreign insurance companies

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In brief

Senate Finance Committee Ranking Member Ron Wyden (D-Ore) introduced The Offshore Reinsurance Tax Fairness Act (ORTFA). The ORTFA would amend the passive foreign investment company (PFIC) rules by providing a bright line numerical test for determining whether a foreign insurance company meets the exception under the PFIC rules.

In detail

PFIC Regime

If a foreign company is a PFIC, US shareholders are generally subject to an interest charge imposed on excess distributions and disposition of the PFIC stock. US shareholders may instead elect to be taxed currently on their proportionate share of the PFIC earnings.

Section 1297 provides that a foreign corporation is a PFIC if either (i) 75 percent or more of its gross income for the taxable year is passive income, or (ii) at least 50 percent of its average assets produce passive income or are held for the production of passive income. Section 1297(b)(1) defines "passive income" as any income of a kind that would be foreign personal holding company income as defined in Section 954(c). Section 1297(b)(2)(B) provides an exception whereby passive income does not include income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.

Background

Section 1297(b)(2)(B) does not provide a bright line for determining whether income is derived in the active conduct of an insurance business. As a result, concern has been expressed that in some cases, overcapitalized foreign companies that do not conduct legitimate insurance operations are utilizing the active insurance exception to shelter income. More than a decade ago, the IRS in Notice 2003-34 indicated it would scrutinize arrangements in which tax benefits that are available only to insurance companies are claimed by entities that do not so qualify by reason of investment activities that exceed their insurances activities.

Since then, legislative proposals have been introduced attempting to address the perceived "loophole" including by Former House Ways & Means Committee Chairman David Camp (R-MI) and Former Senate Finance Committee Chairman Max Baucus (D-MT).

In June 2014, Senator Wyden sent a letter to Treasury Department Secretary Jacob Lew and IRS Commissioner John Koskinen criticizing the failure of the Treasury and the IRS to close a "loophole" wherein investors utilize foreign insurance companies located in tax havens as shelters for investment income earned from hedge funds. In response, the IRS issued Prop. Reg. Section 1.1297-4 to provide guidance on the definitions of "active conduct" and "insurance business" under the Section 1297(b)(2)(B) exception.

The ORTFA

The ORTFA would amend Section 1297(b)(2)(B) to state that passive income "derived in the active conduct of an insurance business by a qualifying insurance company (as defined in subsection (f))" is not passive income for purposes of the PFIC rules. The legislation further would add a new subsection (f) to Section 1297 defining the term "qualifying insurance corporation" for purposes of determining whether certain foreign insurance companies meet the passive income exception under Section 1297(b)(2)(B).

Subsection (f) would define a qualifying insurance corporation as a foreign corporation (i) which would be subject to tax under subchapter L if it were treated as a domestic corporation, and (ii) the applicable insurance liabilities of which constitute more than 25 percent of its total assets, determined on the basis of such liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year. Applicable insurance liabilities include loss and loss adjustment expenses and reserves and cannot exceed the lesser of the amount reported to the applicable insurance regulatory body in the applicable financial statement or as determined under the regulations prescribed by the Secretary. An applicable financial statement includes a financial reporting statement made on the basis of: (i) generally accepted accounting principles, (ii) international financial reporting standards, if there is no statement that meets clause (i), or (iii) a statement required to be filed with the applicable insurance regulatory body (i.e. the entity established by law to license, authorize, or regulate insurance business), if there is no statement that meets clauses (i) or (ii).

A company that does not qualify for the exception because it has 25 percent or less in insurance liability assets, may still be considered a qualifying insurance corporation if its applicable insurance liabilities are at least 10 percent of insurance liability assets and, under regulations prescribed by the Secretary and based on the facts and circumstances, is predominantly engaged in an insurance business and such failure to qualify is due solely to temporary circumstances.

If enacted, the amendments would be effective for taxable years beginning after December 31, 2015.

The takeaway

The ORTFA is a continuation of Senator Wyden's push to close a perceived "loophole" in the PFIC rules. The bright-line test would provide clarity for foreign insurance companies evaluating their qualification for the active insurance exception under the PFIC rules. However, bona fide insurance companies that have assets materially greater than their reserves, such as those that underwrite low frequency, high severity risks (e.g. catastrophic risks), may face difficulties in meeting the prescribed test.

The ORTFA incorporates the applicable insurance liabilities test previously seen in the Camp and Baucus proposals, although it utilizes a 25 percent threshold as compared to a 35 percent threshold in the prior proposals. Additionally, the ORTFA defines applicable insurance liabilities to include loss and loss adjustment expenses and reserves, similar to the Camp and Baucus proposals, but does not include unearned premiums. In contrast to the Camp and Baucus proposals, the ORTFA does not include a gross receipts test with respect to premiums of the foreign corporation or a net written premiums test.

Companies and industry groups that may be affected by changes to the PFIC rules should continue to monitor developments with respect to the ORTFA as well as the proposed PFIC regulations, and consider submitting comments. Comments with respect to the proposed PFIC regulations are due by July 23, 2015.

Let's talk

For a deeper discussion of how this issue might affect you, please contact:

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