

Treasury issues proposed regulations on the PFIC exception for foreign insurance companies

April 24, 2015

In brief

In a notice of proposed rulemaking, the Internal Revenue Service (IRS) issued Prop. Reg. Sec. 1.1297-4 (proposed regulations), to provide guidance on the exclusion of passive income derived in the active conduct of an insurance business by certain foreign insurance companies for purposes of the passive foreign investment company (PFIC) rules. The proposed regulations provide definitions for the previously undefined terms “active conduct” and “insurance business,” as used in Section 1297(b)(2)(B), and the impact of these definitions should be evaluated by all foreign insurance companies.

In detail

The preamble to the proposed regulations states the regulations would “clarify” the circumstances under which investment income earned by foreign insurance companies is derived in the active conduct of an insurance business for purposes of the PFIC rules and, specifically, the passive income exception under Section 1297(b)(2)(B). The effective date of the regulations would be the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register.

Background

Issuance of the notice responds to ranking Democrat on the

Senate Finance Committee Ron Wyden’s (D-Ore) June 2014 letter to Treasury Department Secretary Jacob Lew and IRS Commissioner John Koskinen criticizing the failure of 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. Following publication of the notice, Wyden remarked in a Senate Finance Committee press release that the guidance “serves as an important first step down the path towards better enforcement.” He further indicated that he intends to continue to work on closing “this tax loophole” for good.

Previously, 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 insurance activities.

PFIC regime

If a foreign insurance company is a PFIC, US shareholders are generally subject to an interest charge imposed on income deferral unless current income recognition is elected.

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.

Proposed regulations

Section 1297 does not define the terms “active conduct” and “insurance business.” The proposed regulations define these terms in order to clarify when 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 the extent to which the company’s assets are passive assets under the PFIC rules.

Prop. Reg. Sec. 1.1297-4 provides that the term “active conduct” has the same definition as in Treas. Reg. Sec. 1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities. Although this definition of “active conduct” is otherwise consistent with the approach used to define banking income of an active bank under Prop. Reg. Sec. 1.1296-4, it is unclear why the IRS thought it was necessary to exclude from the definition officers

and employees of related entities for insurance companies.

Additionally, Prop. Reg. Sec. 1.1297-4 defines the term “insurance business” as 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. An investment activity is defined as any activity that would produce income of a kind that would be foreign personal holding company income as defined in Section 954(c). Investment activities are required to support or are substantially related to insurance or 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.

The IRS requests comments on all aspects of the proposed regulations, including comments on how to determine the portion of assets held to meet obligations under insurance contracts issued or reinsured by the company. Although the proposed regulations do not include a method for doing so, the preamble suggests an approach that would treat assets as held to meet obligations under insurance contracts to the extent they do not exceed a specified percentage of total insurance liabilities for the year. Comments are specifically requested on what percentage would be appropriate if this approach were adopted. All comments must be received by July 23, 2015.

The takeaway

The proposed regulations raise a number of questions and could affect a number of foreign insurance companies with US owners. In particular (a) companies that rely on the services of a related company may want to explore engaging in employer/employee relationships instead; (b) companies that outsource core functions, such as underwriting, investment and claims management, or outsource their administrative functions. These companies may want to explore whether they meet the “active conduct” test and whether they should increase the degree of control over their service providers among other things. This is particularly important for captive insurance companies and segregated cells that are treated as insurance companies; (c) companies that have assets materially greater than their reserves such as those that underwrite with low frequency, high severity risks, e.g. catastrophic risks. These companies should consider how they will demonstrate their need for investment assets; and (d) companies in run-off, whose reserves decrease over time, should monitor their investment activities in relation to other activities and determine whether any amounts that are no longer needed in the insurance business should be distributed to shareholders. Companies and industry groups that may be affected by the proposed regulations should consider submitting comments to the IRS and Treasury.

Let's talk

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