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CLIENT ALERT

Treasury's Latest Effort to Address the Insurance Company Exception to the PFIC Rules and Provide Other Long-Awaited PFIC Guidance

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On July 10, 2019, the U.S. Internal Revenue Service (the **"IRS"**) and the Department of Treasury (the **"Treasury Department,"** and collectively with the IRS, **"Treasury"**) released proposed regulations on (1) the application of the Insurance Company Exception (as defined below), which was substantially modified by the Tax Cuts and Jobs Act of 2017 (the **"2017 Act"**) and (2) long-awaited guidance on a range of issues relating to passive foreign investment companies (**"PFICs"**) that have been left unanswered since the PFIC rules were introduced as part of the 1986 U.S. tax reform (such as determining ownership of a PFIC and applying the Income Test and Asset Test (as those terms are defined below) to determine PFIC status) (The **"2019 Proposed Regulations"**). The 2019 Proposed Regulations, taken together with the 2017 Act, could have substantial ramifications for U.S. investors in offshore insurance and reinsurance structures, including traditional global insurance and reinsurance corporate structures, insurance-linked securities funds and insurance-linked securities issuers. A U.S. taxable investor in the shares of an offshore insurer or reinsurer group is generally able to defer U.S. taxation until a sale of its shares and, if held long enough, pay tax on such sale at long-term capital rates if, among other things, the offshore insurer or reinsurer group qualifies for the Insurance Company Exception. If the PFIC rules were to apply to a U.S. taxable investor in an offshore insurance or reinsurance structure, the U.S. taxable investor would lose some or all of the benefits of U.S. tax deferral and long-term capital gain treatment. The 2019 Proposed Regulations withdraw prior regulations proposed in 2015 related to the Insurance Company Exception that were widely criticized by the insurance industry as ignoring market practice and realities (the **"2015 Proposed Regulations"**). The 2019 Proposed Regulations are similarly flawed in some cases (including their use of terms and phrases not commonly used in the insurance industry without defining such terms and phrases), and the Treasury Department and IRS again are reaching out to the industry for comments in a number of areas.

I. General Summary of the PFIC Rules and the Insurance Company Exception.

The Internal Revenue Code of 1986, as amended (the **"Code"**), provides that a foreign corporation will be considered a PFIC if in any taxable year either (1) 75% or more of its gross income in such taxable year is passive income (the **"Income Test"**) or (2) the average percentage of assets held by such corporation during the taxable year that produce passive income is at least 50% (the **"Asset Test"**). Passive income is defined by reference to foreign personal holding company income (**"FPHCI"**) under the controlled foreign corporation (**"CFC"**) rules and includes dividends, interest, royalties, rents and other types of investment income. The PFIC rules provide that income derived in the active conduct of an insurance business by a qualifying insurance corporation (the "**Insurance Company Exception**") will not be treated as passive income. The 2017 Act limited the Insurance Company Exception to a non-U.S. insurance company that is a qualifying insurance corporation (**"QIC"**), which is a foreign corporation that would be taxable as an insurance company if it were a U.S. corporation and that either (i) maintains "applicable insurance liabilities" (**"AILs"**) of more than 25% of such company's total assets as shown on the company's "applicable financial statement" (**"AFS"**) for a taxable year (the **"25% Test"**) or (ii) maintains AILs that at least equal or exceed 10% of its total assets for the taxable year, is predominantly engaged in an insurance business and satisfies a facts and circumstances test that requires a showing that the failure to exceed the 25% threshold is due to runoff or rating agency circumstances (the **"10% Test"**). The 10% Test would require a U.S. investor to elect to treat the foreign corporation as a QIC, although the method of election is not prescribed by the Code. AILs mean (i) losses and loss adjustment expenses and (ii) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks, and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. The Code provides a cap on the AILs equal to the lesser of the amount reported to the applicable insurance regulatory body in the AFS (or, if less, the amount required by applicable law or regulation) or as determined under Treasury regulations. The AFS is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles (**"GAAP"**) or international financial accounting standards (**"IFRS"**) (if no statement is prepared for financial reporting purposes on the basis of GAAP). If no statement is prepared for financial reporting purposes on the basis of GAAP or IFRS, the AFS would be the annual statement required to be filed with the applicable insurance regulatory body (except as otherwise provided in Treasury regulations). The "applicable insurance regulatory body" means, with respect to any insurance business, the entity established by law to license, authorize or regulate such business and to which an annual statement is provided. The QIC test could result in the application of the PFIC rules to offshore insurance and reinsurance structures that write business on a low frequency/high severity basis and take on significant insurance risk, such as property catastrophe companies (including insurance-linked securities funds) and financial or mortgage guaranty companies that generally do not book reserves for losses until a catastrophic or credit event occurs, a result that would seem at odds with the legislative purpose underlying the modifications to the Insurance Company Exception (that is, these are not companies conducting a token insurance business while focusing primarily on investment activities).

For purposes of the Asset Test and Income Test, a foreign corporation will be considered to (1) hold its proportionate share of the assets of a corporation and (2) directly receive its proportionate share of the income of a corporation if the foreign corporation owns, directly or indirectly, at least 25% (by value) of the stock of the other corporation (the **"Look-Through Rule"**).

A special characterization rule also applies to the determination of whether a foreign corporation is a PFIC where such foreign corporation owns at least 25% (by value) of the stock of a U.S. corporation, which in turn holds the stock of another U.S. corporation other than a regulated investment company or a real estate investment trust (**"qualified stock"**). Under this provision, in determining whether a foreign corporation is a PFIC, (1) the stock of the second-tier U.S. corporation held by such first-tier U.S. corporation will not be considered to be an asset that produces passive income and (2) dividends from such second-tier U.S. corporation to the first-tier U.S. corporation will not be treated as passive income, provided that the foreign corporation is subject to the accumulated earnings tax (the **"Special Characterization Rule"**).

The application and coordination of the Look-Through Rule and the Special Characterization Rule are not statutorily addressed and may produce different results in analyzing whether a foreign corporation should be treated as a PFIC.

II. Proposed Regulations on Insurance Company Exception.

As noted above, the Insurance Company Exception would only apply to income derived in the active conduct of an insurance business by a QIC. The 2019 Proposed Regulations provide guidance on the three requirements—QIC status, insurance business and active conduct.

1) QIC Status

   a) General Test

A foreign corporation will be treated as a QIC if it would be taxed as an insurance company under subchapter L if it were a domestic corporation and its AILs meet the 25% Test (or the 10% Test, assuming the U.S. investor elects to treat the foreign corporation as a QIC). The 2019 Proposed Regulations define an insurance company by reference to the Code—that is, as a company more than half the business of which during the taxable year is the issuance of insurance or annuity contracts or the reinsurance of risks underwritten by insurance companies. The 25% Test will be met if the amount of the foreign corporation's AILs exceeds 25 percent of its total assets based on the corporation's AFS for the last year ending with or within the taxable year. The 2019 Proposed Regulations define AILs as (1) occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts and health insurance benefits, together with unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusting such unpaid losses and (2) the aggregate amount of reserves (excluding deficiency, contingency or unearned premium reserves) held for future unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks, including annuity benefits dependent on life expectancy of one or more individuals. The meaning of "occurred losses" (which is not a term of art in the insurance industry) is unclear, as is the requirement that the foreign corporation has become liable for such losses before the end of the last annual reporting period (which presumably does not mean a final determination as to the liability and amount). The 2019 Proposed Regulations further tightened the AIL cap in the Code by providing that the amount of AILs may not exceed the lesser of (1) the amount of AILs shown on the most recent AFS, (2) the *minimum* amount of AILs required by the applicable law or regulation of the jurisdiction of the applicable regulatory body, or (3) in the case of a foreign corporation that prepares a financial statement on the basis of a "financial reporting standard" (defined as U.S. GAAP or IFRS) for a purpose other than financial reporting, the amount of the AILs shown on that financial statement (on the theory that Congress has expressed a preference for widely used standards of financial accounting). Treasury found it appropriate to limit the amount of AILs to the minimum amount required to be reported to the insurance regulator, even if the regulator would accept a higher amount for regulatory purposes.

Further, if the AFS is not prepared on the basis of U.S. GAAP or IFRS and the AILs are not discounted on an economically reasonable basis, the AILs must be discounted under U.S. GAAP or IFRS principles. The preamble to the 2019 Proposed Regulations sets out the facts and circumstances that are to be considered in the determination of whether AILs are discounted on an economically reasonable basis (for example, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurers in comparable lines of business). Finally, if a foreign corporation has prepared financial statements on a U.S. GAAP or IFRS basis prior to December 22, 2017 or any subsequent annual reporting period and switches to a method other than U.S. GAAP or IFRS without a non-U.S. Federal tax business purpose, it will be treated as having no AILs for purposes of the QIC determination.

For purposes of the 25% Test and the 10% Test, total assets are the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its AFS for the last annual accounting period ending with or within the taxable year.

b) Alternative Facts and Circumstances Test

As discussed above, a U.S. person can elect to treat stock in a foreign corporation as stock of a QIC if the 10% Test is met. The 2019 Proposed Regulations provide guidance on the 10% Test requirements.

(i) Predominantly Engaged- A foreign corporation would be considered predominantly engaged in an insurance business despite the low ratio of AILs to assets if it meets the insurance company test described above and satisfies an additional facts and circumstances test to establish that certain facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions. The relevant facts and circumstances include claims payment patterns, loss exposure as calculated for a regulator or rating agency (or, if not, for internal pricing purposes), the percentage of gross receipts constituting premiums and the number and size of insurance contracts issued or reinsured. Negative factors that would influence the "predominantly engaged" analysis include a small number of insured risks with low likelihood but large potential costs, low loss exposure and a greater focus on investment relative to underwriting by employees and agents of the foreign corporation.

(ii) Runoff-Related or Rating-Related Circumstances- The 2019 Proposed Regulations provide that runoff-related circumstances occur when a foreign corporation (1) has adopted a plan of liquidation or termination of operation under the supervision of its applicable insurance regulatory body, (2) does not issue new contracts during the taxable year (other than certain contractually obligated renewals of existing contracts) and (3) makes claims payments during the annual reporting period covered by the AFS and such payments cause the corporation to fail the 25% Test (the preamble did not indicate that the payments must cause the failure to meet the 25% Test as a consideration to the application of the runoff-related circumstances test).

The 2019 Proposed Regulations also provide some color with respect to rating-related circumstances, although the terminology is not commonly used in the insurance industry. A rating-related circumstance occurs when a generally recognized credit agency requires the foreign corporation to maintain a surplus of capital to receive or maintain a minimum credit rating for the foreign corporation to be classified as secure to write new insurance business for the current year. Because some lines of insurance business require higher minimum credit ratings than others, the preamble to the 2019 Proposed Regulations expresses the intent to apply the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business (presumably to provide relief to foreign insurers writing multiple lines). Treasury acknowledged that in the case of certain lines of business, such as financial guaranty, market reality may require a credit rating higher than the minimum, but did not address that situation.

c) Election Mechanics

The 2019 Proposed Regulations provide that the foreign corporation with respect to which the election is made must directly provide the electing U.S. person with a statement or make a publicly available statement (such as in a public filing, disclosure statement or other notice to U.S. shareholders of the foreign corporation) that it met the 10% Test, including certain information relevant to this statement (which cannot be relied upon by a U.S. person who knows or has reason to know the statement was incorrect). The U.S. person would need to make the election on Form 8621 for each year in which the election applies (together with the statement provided by the foreign corporation) and check the box regarding the QIC election. Comments were requested to reduce the burden on small shareholders with respect to this election.

2) Insurance Business

The 2019 Proposed Regulations define insurance business as the business of issuing insurance or annuity contracts and/or reinsuring risks underwritten by other insurance companies, including investment activities and administrative services required to support or substantially related to those contracts. For this purpose, investment activity means any activity to generate passive income, but only to the extent that income provided by the activity is generated by assets that a QIC holds that are available to satisfy its liability under insurance or annuity contracts issued or reinsured by a QIC. As all of the assets held by a QIC presumably are available to satisfy its insurance liabilities, the limitation in the latter part of the definition of investment activity appears unnecessary.

3) Active Conduct of an Insurance Business

The 2019 Proposed Regulations provide that the Insurance Company Exception to passive income applies to income that a QIC derives in the active conduct of an insurance business and income from a qualifying domestic insurance corporation (**"QDIC"**). The determination of whether a QIC is engaged in the active conduct of an insurance business is based on facts and circumstances and generally requires the officers and employees of the QIC to carry out substantial managerial and operational activities. Unlike the 2015 Proposed Regulations, the 2019 Proposed Regulations allow the QIC to take into account activities of officers and employees of certain related entities, provided that the QIC exercises regular oversight and supervision over the services performed by the related entity's officers and employees (with no guidance provided on the meaning of "oversight and supervision") and that certain compensation arrangement requirements are satisfied.

The 2019 Proposed Regulations introduced a new concept known as the "active conduct percentage" to function as a proxy for the determination of whether a QIC is engaged in the active conduct of an insurance business, defining the active conduct percentage for a taxable year as (i) the aggregate amount of expenses, including compensation (or reimbursement of compensation) and related expenses, for services of the officers or employees of the QIC and certain related parties incurred by the QIC for the taxable year that are related to the production or acquisition of premiums and investment income on assets held to meet its obligations under insurance, annuity or reinsurance contracts issues or entered into by the QIC, divided by (ii) all such expenses regardless of the service provider. Ceding commissions are not taken into account for purposes of this percentage. Income that a QIC derives in the active conduct of an insurance business is defined by the 2019 Proposed Regulations as an amount equal to the QIC's passive income taking into account exceptions other than the Insurance Company Exception earned with respect to assets of a QIC that are available to satisfy liabilities of the QIC related to its insurance business if the "active conduct percentage" for the taxable year is 50 percent or more and zero if the "active conduct percentage" falls below this 50 percent threshold. Similarly, for purposes of the Asset Test, passive assets will not include (i) assets of a QIC available to satisfy its liabilities related to its insurance business if the "active conduct percentage" of the QIC is at least 50 percent and (ii) assets of a QDIC. This test reflects an attempt by Treasury to provide a bright line test for measuring a QIC's active conduct, and comments were requested on whether this "all or nothing" test is a good proxy for active conduct or whether it should be a safe harbor alongside a facts and circumstances test.

For purposes of applying the Look-Through Rule, as well as the Look-Through Partnership Rule (described below), an item of income treated as received or accrued or an asset treated as held by the QIC under the Look-Through Rule or the Look-Through Partnership Rule that would be passive at the subsidiary entity level is treated as an item of income or an asset of the QIC for purposes of the Insurance Company Exception. However, such item of income or asset will only be treated as used in the active conduct of an insurance business by a QIC if the AFS used to test the QIC status of the foreign corporation includes the assets and liabilities of the subsidiary entity.

As discussed above, the income and assets of a QDIC would not be treated as passive. A QDIC is a U.S. corporation subject to tax as an insurance company under subchapter L of the Code and that is subject to federal income tax on its net income. This rule is intended to address situations where a foreign corporation that is determining its status under the PFIC rules owns a domestic insurance company through a structure where the Special Characterization Rules do not apply. However, this rule would not apply for purposes of determining whether a foreign corporation is a PFIC for purposes of the corporate attribution rules that determine indirect ownership of lower-tier PFICs.

The 2019 Proposed Regulations also provide that no item can be counted more than once, including, for example, determining AIL for purposes of the 25% Test and the 10% Test.

III. Proposed Regulations on General PFIC Issues

As noted above, the 2019 Proposed Regulations provide guidance on issues related to ownership of a PFIC and the application of the Income Test and Asset Test for determining PFIC status. The following discussion briefly describes some of these provisions of the 2019 Proposed Regulations.

1. Application of the Corporate Attribution Rules

The 2019 Proposed Regulations would apply a "top down" approach to the ownership attribution rules when a pass-through entity with a U.S. owner(s) holds the stock of a PFIC indirectly through a foreign corporation that is not a PFIC.

2. Exempt Income

For purposes of applying the Income Test, intercompany dividends received by a domestic corporation and treated as received by a foreign corporation being tested for PFIC status under the Look-Through Rule would be taken into account even if such dividends are excluded under the consolidated return rules, subject to rules that eliminate double counting (discussed below).

3. Application of Exceptions to FPHCI in the CFC Context

As discussed above, passive income for purposes of the PFIC rules is defined by reference to the definition of FPHCI under the CFC rules. The 2019 Proposed Regulations provide that only certain of the exceptions to the definition of FPHCI carry over to determine passive income under the PFIC rules, specifically excluding, among other items, the exception for income from an active insurance business (Treasury concluded that the recent statutory changes to the Insurance Company Exception in the 2017 Act and the related tests should govern).

4. Income Earned and Assets Held Through Partnerships

The 2019 Proposed Regulations provide that a foreign corporation's distributive share of income of a partnership is treated as income received directly by the foreign corporation if it owns, directly or indirectly, at least 25 percent of the value of the partnership (such partnership will be considered a **"Look-Through Partnership"**), treating income earned through partnerships similarly to income earned through corporate subsidiaries (the **"Look-Through Partnership Rule"**). Similarly, a foreign corporation with an interest in a Look-Through Partnership would be treated as owning its proportionate share of the partnership assets for purposes of the Asset Test. If the 25 percent ownership threshold is not met, the foreign corporation's distributive share of the partnership's income would be treated as passive and the partnership interest would be treated as a passive asset. To qualify for an exception to passive income that is based on activities, the Look-Through Partnership itself generally must be engaged in the relevant activities (which differs from the CFC rules).

5. Methodology of Applying the Asset Test

The 2019 Proposed Regulations generally apply quarterly testing (although more frequent measurement periods may be used and special rules are provided for short taxable years). The average percentage of a foreign corporation's assets is determined using the average of gross values (or adjusted bases) at the end of each measurement period rather than on the basis of passive asset percentage at the end of each measurement period. The 2019 Proposed Regulations also provide rules with respect to dual character assets (part passive/part active).

6. Application of the Look-Through Rule

If a foreign corporation owns directly or indirectly at least 25 percent of the value of the stock of another corporation (such as the corporation referred to as a **"Look-Through Subsidiary"**), the foreign corporation will be treated as directly holding its proportionate share of the assets and directly receiving its proportionate share of the income of the Look-Through Subsidiary for purposes of the Asset Test and Income Test (subject to the Special Characterization Rules described below). The 2019 Proposed Regulations provide that indirect ownership means ownership through entities (whether domestic or foreign) and set forth rules for determining whether the 25 percent ownership test is met for purposes of the Income Test and the Asset Test. Guidance related to the elimination of certain intercompany payments and assets for purposes of the Income Test and the Asset Test in cases where the Look-Through Rule apply are also included in the 2019 Proposed Regulations.

7. Ownership Between the Look-Through Rule and the Special Characterization Rule

The 2019 Proposed Regulations generally give priority to the Special Characterization Rule when there is potential overlap with the Look-Through Rule, on the theory that the Special Characterization Rule is the more specific rule where a foreign corporation owns (directly or indirectly through a partnership) at least 25 percent by value of a domestic corporation that owns qualified stock of other domestic corporations. However, this overlap rule is subject to certain limitations and anti-abuse rules. The 2019 Proposed Regulations also clarify that the accumulated earnings tax need not be actually imposed on the foreign corporation and the foreign corporation need not have U.S. source income for the Special Characterization Rule to apply.

8. Change of Business

The 2019 Proposed Regulations provide guidance on the exception to PFIC status for foreign corporations that transition from one active business to another.

IV. Concluding Preliminary Observations

The 2019 Proposed Regulations represent a mixed bag for foreign-parented global insurers and reinsurers. Although dispensing with the requirement included in the 2015 Proposed Regulations that core insurance activities (including investment activities) be conducted by officers and employees of the foreign (re)insurer without taking into account any activities conducted by related parties to satisfy the active conduct test, the 2019 Proposed Regulations introduce the concept of active conduct percentage, which may cause foreign parented global (re)insurers that outsource investment management, administrative and other functions to be characterized as PFICs even when assuming significant (re)insurance risk and maintaining robust underwriting and management teams. In addition, the exceptions to the application of the QDIC rules and the coordination of the Look-Through Rule and the Special Characterization Rule could produce surprising results for foreign-parented global (re)insurance groups with substantial U.S. operations, such as the treatment of U.S. shareholders of the foreign parent as indirect shareholders of lower tier PFICs (such as foreign reinsurers that are not QICs) in situations where the foreign parent itself is not a PFIC. The inability to treat passive income or assets owned by a QIC under the Look-Through Rule or Look-Through Partnership Rule as nonpassive pursuant to the Insurance Company Exception unless the AFS used to test the QIC status incudes the assets and liabilities of the subsidiary entity could also result in unexpected PFIC characterization.

In the insurance-linked securities space, catastrophe bond issuers and, in some cases, "pure" sidecars historically have been treated as PFICs. The 2017 Act resulted in PFIC characterization of most sidecars assuming predominantly catastrophe business (whether "pure" or "market facing") and insurance-linked securities funds that were structured to avoid PFIC characterization through large books of collateralized reinsurance relative to the overall investments, as much of the collateralized reinsurance was not expected to produce adequate reserves under the 25% Test (even though, as noted earlier, such funds were assuming significant insurance risk). The 2019 Proposed Regulations do not appear to change the PFIC characterization in these cases.

The 2019 Proposed Regulations will become effective once finalized, although taxpayers may apply the provisions of the regulations dealing with the Insurance Company Exception to taxable years beginning after December 31, 2017, and all other provisions to all open taxable years as if they were final, provided that the rules are applied consistently. Treasury has solicited comments on many aspects of the 2019 Proposed Regulations, and it is expected that a barrage of comments from the insurance industry will be forthcoming.

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