CLIENT ALERT

Treasury's Third Effort to Address the Insurance Company Exception to the PFIC Rules Produces a Mix of Final and Proposed Regulations

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On December 4, 2020, the U.S. Internal Revenue Service (the **"IRS"**) and the U.S. Department of Treasury (collectively with the IRS, **"Treasury"**) released final and proposed regulations on (1) the implementation 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 general 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 **"2020 Regulations"**). The 2020 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 and the U.S. taxable investor is not subject to other U.S. anti-deferral regimes. 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 2020 Regulations finalized portions of regulations proposed in 2019 (with modifications in some cases) (the **"2020 Final Regulations"**) while withdrawing some of the 2019 proposals and issuing new proposed rules (the **"2020 Proposed Regulations"**). The 2019 proposed regulations were discussed in our client alert of July 17, 2019. The 2020 Regulations responded to comments and criticism from the insurance industry to some

extent, and Treasury again is reaching out to the industry for comments in a number of areas. The 2020 Regulations generally apply (or are proposed to apply) for taxable years beginning on or after the date they are filed in the Federal Register, although they may be applied to earlier periods subject to a consistency requirement.

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. 2020 Final 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 2020 Final Regulations provide guidance on two of these requirements–QIC status and insurance business. The discussion below highlights the changes made to the 2019 proposed regulations.

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 of the Code 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 2020 Final Regulations adopted the approach of the 2019 proposed regulations by defining an insurance company by reference to the Code. The 2020 Final Regulations modified the definition of AILs to conform to industry terminology, clarifying that AILs include incurred losses (unpaid losses and incurred but not reported losses) and unpaid loss adjustment expenses, regardless of whether the underlying losses were paid or unpaid. However, Treasury did not expand the definition of AILs to cover paid losses or paid loss adjustment expenses or revise the definition to provide special rules for financial guaranty and mortgage insurers. The 2020 Final Regulations also specify that amounts held by an insurer as a deposit liability (e.g., a guaranteed investment contract,

funding agreement, etc.) or any other substantially similar contract issued by an insurer, as well as the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life or life expectancy of one or more individuals are not AILs. The 2020 Final Regulations further provide that only the AILs of the foreign insurer that is being tested for QIC status are taken into account (not the AILs of other members of a consolidated financial group).

The 2020 Final Regulations also modified the AIL cap set out in the 2019 proposed regulations to the lesser of (1) the amount shown on any financial statement filed with the applicable insurance regulator, (2) the amount determined on the most recent AFS if prepared on the basis of U.S. GAAP or IFRS (even if not filed with an insurance regulator) or (3) the amount required by applicable law or regulations of the jurisdiction of the applicable regulator (or lower amount allowed as a permitted practice). Further, the definition of financial statement was revised to treat a statement as such only if it is prepared for a reporting period in accordance with the rules of a financial statutory accounting standard and includes a complete balance sheet, income statement and cash flow statement. 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 applicable U.S. GAAP or IFRS principles to the extent the AILs would be discounted under those principles (with the choice of U.S. GAAP or IFRS left with the foreign insurer).

Finally, Treasury noted that the AFS balance sheet is a starting point for determining the amount of AILs, and that it may be necessary to disaggregate components of balance sheet liabilities to arrive at the proper amount of AILs (noting that IFRS 17, which is scheduled to be effective January 1, 2023, provides for a balance sheet item of "overall insurance liabilities" which encompasses claims reserves (an AIL) and unearned premium reserves (specifically excluded from AILs)).

b) Alternative Facts and Circumstances Test

As discussed above, a U.S. person can elect to treat stock in a foreign insurer as stock of a QIC if the 10% Test is met. The 2020 Final Regulations provide guidance on the 10% Test requirements.

(i) Predominantly Engaged- The 2020 Final Regulations make clear that a foreign corporation would be considered predominantly engaged in an insurance business if it meets the insurance company test described above *and* satisfies an additional facts and circumstances test that is based upon the character of the business actually conducted in the taxable year, but deleted the requirement in the 2019 proposed regulations that the facts and circumstances of the foreign insurer be comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's-length transactions. The relevant facts and circumstances in the 2019 proposed regulations were adopted in the 2020 Final Regulations (which also clarified that the list of factors was not exclusive).

(ii) Runoff-Related or Rating-Related Circumstances- The 2020 Final Regulations modified the runoff-related circumstances test by eliminating the requirements that (1) the runoff company have a plan of liquidation (instead

requiring the runoff company to be in the process of terminating its preexisting active conduct of an insurance business) and (2) claims payments cause the foreign insurer to fail the 25% Test (while retaining the requirement that claims payments are made during the annual reporting period).

The 2020 Final Regulations revised the rating-related circumstances standard to conform to industry terminology by requiring that the 25% Test is not satisfied due to capital and surplus amounts that a generally recognized credit rating agency considers necessary for the foreign insurer to obtain a public rating of its financial strength and the foreign insurer maintains such capital and surplus to obtain the minimum credit rating necessary to enable it to write the business in its regulatory or board supervised business plan. However, the 2020 Final Regulations inexplicably restricted the rating-related circumstances to financial guaranty insurers, certain mortgage insurers and insurers writing a specified amount of catastrophe risk (specifically noting in the preamble that no special rule was created for fully collateralized reinsurers, which typically do not obtain credit ratings).

c) Election Mechanics

The 2020 Final Regulations modified some of the election mechanics to apply the 10% Test, including revisions to the shareholder reliance on the foreign insurer's statement relating to the 10% Test, allowing a foreign parent to make the statement on behalf of its subsidiaries and providing for certain deemed elections by small shareholders in publicly traded corporations.

2) Insurance Business

The 2020 Final Regulations retained the definition of insurance business in the 2019 proposed regulations, which includes investment activities required to support or substantially related to the insurance contracts written by the foreign insurer. Treasury noted that this definition is not intended to provide a maximum threshold for investment assets and income that may qualify for nonpassive treatment, but merely requires a sufficient factual relationship between a foreign insurer's insurance contracts and its investment activities.

3) Active Conduct of an Insurance Business

The 2019 proposed regulations provided 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"**) and provided that the treatment of a QIC's income derived from the active conduct of an insurance business was based on a rigid active conduct percentage test that did not comport with insurance industry practice. Treasury responded to industry comments on the active conduct test set forth in the 2019 proposed regulations by proposing a more flexible test for determining whether a QIC is engaged in the active conduct on insurance business, reflecting Treasury's understanding that certain outsourcing arrangements are common practice in the insurance industry. The 2020 Proposed Regulations on active conduct will be discussed in Section III below.

The 2019 proposed regulations provided that the income and assets of a QDIC would not be treated as passive. In the preamble to the 2020 Final Regulations, Treasury noted that this nonpassive treatment should be limited if certain thresholds are breached and the 2020 Proposed Regulations introduce a new limitation (discussed in Section III below). 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 QDIC 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, and the 2020 Final Regulations explicitly provide that a QDIC only includes a subsidiary subject to the Look-Through Rule. This rule would not have applied 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 under the 2019 proposed regulations; however, the 2020 Final Regulations eliminated this rule.

For purposes of applying the Look-Through Rule, as well as the Look-Through Partnership Rule (defined below), the 2019 proposed regulations provided that 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 only would have been 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 included the assets and liabilities of the subsidiary entity under the 2019 proposed regulations. In response to comments noting that the equity value of a subsidiary entity is reflected on the QIC's AFS even if not consolidated for financial accounting purposes, the 2020 Final Regulations modified the look-through rules to apply in all cases, but limited the amount of assets that could be treated as nonpassive to the greater of (1) the product of (a) the QIC's proportionate share of the subsidiary entity's income or assets and (b) a fraction the numerator of which is the net equity value of the QIC's interest in the subsidiary entity and the denominator of which is the value of the subsidiary entity's assets or (2) the QIC's proportionate share of amount of income or assets that are considered nonpassive in the hands of the subsidiary entity. In situations where the Look-Through Rule and Look-Through Partnership Rule do not apply (e.g., the QIC ownership interest is less than 25% of a look-through subsidiary), the stock or partnership interest (and income derived therefrom) is eligible for the Insurance Company Exception under the general rules.

III. 2020 Proposed Regulations on the Insurance Company Exception

1) AILs and Total Assets

The 2020 Proposed Regulations provide that AILs are reduced by an amount of assets reported on the AFS that represent reinsurance recoverables. Treasury found this rule is necessary because, for example, U.S. GAAP records reinsurance recoverables with respect to unpaid insurance losses and other reserves on the asset side of the balance sheet, which could lead to a manipulation of the ratio tests. The 2020 Proposed Regulations also provide for a reduction of the AILs for liabilities that may be recoverable from another entity included in a consolidated financial statement,

regardless of whether the reinsurance transaction is eliminated in consolidation. The 2020 Proposed Regulations also provide for a corresponding optional adjustment to total assets, as well as an adjustment to total assets in situations where a foreign insurer's AFS is prepared on a consolidated basis and the insurance liabilities of affiliated entities are not included as part of the AIL of the subject foreign insurer. In the preamble to the 2020 Proposed Regulations, Treasury discussed modified coinsurance (**"modco"**) reinsurance arrangements where the ceding company continues to hold the reserves and assets required to support the reinsured liabilities and noted that the proposed rules related to reinsurance recoverables are not intended to apply to modco arrangements.

2) AFS Ordering Rules

The 2020 Proposed Regulations provide rules in addition to the general ordering rules in the Code relating to the order of priority between multiple financial statements prepared at the same level of priority (e.g., multiple financial statements prepared on a U.S. GAAP basis) and between multiple financial statements taking into account the assets and liabilities of different legal entities (e.g., nonconsolidated financials take priority over consolidated if both prepared on U.S. GAAP basis). Further, only audited financial statements may qualify as the foreign insurer's AFS.

3) Active Conduct

As discussed above, the active conduct percentage test set forth in the 2019 proposed regulations drew widespread criticism, and the 2020 Proposed Regulations allow for a more flexible approach to the satisfaction of the active conduct test through either a factual requirements test or a modified active conduct percentage test.

a) Active Conduct Exclusions

The 2020 Proposed Regulations provide that a QIC cannot meet the active conduct test if (1) it has no (or a nominal number of) employees and relies exclusively (or almost exclusively) on independent contractors to perform its core functions or (2) it is a securitization vehicle (such as a catastrophe bond issuer, sidecar or collateralized reinsurer) or an insurance-linked securities fund that invests in securitization vehicles. The exclusion of the latter category of QICs was based on Treasury's determination that such vehicles are designed to provide an investment return that is tied to the occurrence of a fixed or predetermined portfolio of insured risks, events or indices related to insurance risks rather than to participate in the earnings of an active insurance business. It is not clear whether the second exclusion would extend to a market-facing sidecar or an insurance-linked securities fund that primarily writes reinsurance swaps characterized as reinsurance for U.S. federal tax purposes.

b) Factual Requirements Test

A QIC will satisfy this test if (1) the officers and employees of the QIC carry out substantial managerial and operational activities on a regular and continuous basis with respect to its core functions (which include underwriting, investment,

contract and claims management (unless the QIC is a reinsurer that delegates this function to the cedent in an indemnity reinsurance transaction) and sales activities) *and* (2) the QIC's officers and employees perform virtually all of the active decision-making functions relevant to underwriting functions (i.e., the underwriting activities that are most important to the QIC's decisions related to assumption of specific insurance risks). The 2020 Proposed Regulations provide specific definitions for substantial managerial and operational activities, the components of core functions and active decision-making functions. Development of underwriting policies and parameters that are modified infrequently is not considered an active decision-making function in the absence of further ongoing active involvement in day-by-day decision-making.

c) Active Conduct Percentage Test

The active conduct percentage test will be satisfied if (1) the total costs incurred by the QIC with respect to its officers and employees (including officers and employees of certain related entities) for services related to core functions (other than investment activities) at least equal 50% of the total costs incurred for all such services and (2) the QIC's officers and employees oversee any part of the QIC's core functions, including investment management, that are outsourced to an unrelated party. Investment activities were eliminated from the first part of the test by the 2020 Proposed Regulations in response to industry comments on the 2019 proposed rules. Services provided by officers and employees of certain related entities are only taken into account in the numerator of the active conduct percentage if the QIC exercises regular oversight and supervision over such services and compensation arrangements meet certain requirements. Ceding commissions and brokerage or agents' fees are not taken into account for purposes of the active conduct percentage test.

4) QDIC

As noted earlier, the Proposed Regulations introduce limits on the amount of a QDIC's income and assets that could be treated as nonpassive. Those limits are based on a percentage of the QDIC's total insurance liabilities (200% for a life insurance company and 400% for a nonlife insurance company). The total insurance liabilities for a nonlife company is defined as the sum of its unearned premiums and unpaid losses, and a life company's total insurance liabilities is the sum of its Code Section 816 total reserves and certain reserve items described in Code Section 807(c) (to the extent not included in total reserves).

IV. 2020 Regulations on General PFIC Issues

As noted above, the 2020 Regulations provided long-awaited general guidance on a range of PFIC-related issues. The following discussion briefly describes some of these provisions.

1) Application of the Corporate Attribution Rules

The 2020 Final Regulations would apply the "top down" approach to the ownership attribution rules set forth in the 2019 proposed regulations with respect to a pass-through entity with a U.S. owner(s) that holds the stock of a PFIC indirectly through a foreign corporation that is not a PFIC and extend this approach to corporations.

2) CFC/PFIC Overlap

Treasury declined to provide rules in situations where the PFIC and CFC rules overlap, including the interaction with the related person insurance income rules, noting that such coordination rules were beyond the scope of this rulemaking.

3) Active Banking Exception

Treasury did not adopt the provision in the 2019 proposed regulations providing an exception to the definition of passive income for certain active banking income described in Code Section 954(h) which, in the case of a CFC, would be excluded from FPHCI; however, certain principles of Code Section 954(h) would apply for purposes of the active banking exception to passive income under the 2020 Proposed Regulations. The 2020 Proposed Regulations do not provide that principles of Code Section 954(i), which excludes from FPHCI certain active insurance income in the case of a CFC, would apply for purposes of determining PFIC status.

4) Effectively Corrected Income (**"ECI"**)

Treasury determined that an exclusion of ECI from passive income is inconsistent with the statutory definition.

5) Asset Test

Although the Asset Test generally looks to the adjusted basis of a tested foreign corporation's assets in the case of a CFC, the 2020 Final Regulations provide that this rule would not apply if the corporation is a CFC solely as a result of the repeal of Code Section 958(b)(4), disregarding downward attribution from foreign persons.

6) Working Capital

The 2020 Proposed Regulations provide a limited exception to the treatment of working capital as passive to take into account the short-term funding needs of operating companies.

7) Income Earned and Assets Held Through Partnerships

The 2020 Final Regulations revised the definition of a "**Look-Through Partnership"** to more closely align with a look-through corporate subsidiary, 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% 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, unless the corporation is treated as an active partner (that is, a foreign corporation that would not be a PFIC under the Income Test and Asset Test if the tests were applied without taking into account partnership interests owned by the foreign corporation that do not qualify as Look-Through Partnerships).

8) Ownership Between the Look-Through Rule and the Special Characterization Rule

The 2020 Final Regulations adopted the approach of the 2019 proposed regulations in generally giving 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 at least 25% by value of a domestic corporation that owns qualified stock of other domestic corporations. However, the Special Characterization Rule is subject to certain limitations and anti-abuse rules which were modified by the 2020 Regulations.

If you have any questions regarding this client alert, please contact the following attorney or the Willkie attorney with whom you regularly work.

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