

CLIENT MEMORANDUM

Treasury Department and IRS Release Proposed Regulations Clarifying Application of PFIC Analysis to Offshore Reinsurers

April 24, 2015

AUTHORS

Arthur J. Lynch | **Richard L. Reinhold**

A U.S. taxable investor in an offshore reinsurer is generally able to defer U.S. taxation until a sale of its shares in the offshore reinsurer and to pay tax on such sale at long-term capital gain rates, if, among other things, the offshore reinsurer qualifies for an exception to classification as a passive foreign investment company (“PFIC”) because it is treated as an insurance company for U.S. tax purposes that is predominantly engaged in the insurance business and is engaged in the active conduct of an insurance business (the “Active Conduct Exception”).

Legislative proposals were introduced in 2014 that sought to broaden the PFIC definition in an effort to deny the Active Conduct Exception to insurers that were not writing enough insurance business. Further, former Senate Finance Committee Chairman, now ranking minority member, Ron Wyden (D. Ore.) encouraged the Treasury Department and the Internal Revenue Service to develop a test to distinguish insurance companies that qualify for the Active Conduct Exception from those operating as offshore investment vehicles. These proposals were primarily aimed at so-called “hedge fund” reinsurers. On April 23, 2015, proposed Treasury Regulations (the “Proposed 1297 Regulations”) were released that define types of activities an offshore reinsurer must engage in for it to qualify for the Active Conduct Exception by defining the terms “active conduct” and “insurance business”—two terms that had not been previously defined for purposes of this analysis.

Treasury Department and IRS Release Proposed Regulations Clarifying Application of PFIC Analysis to Offshore Reinsurers

Continued

The proposed regulations import the definition of active conduct from another section of the regulations—Treasury Regulations Section 1.367(a)-2T(b)(3) (the “367 Active Conduct Regulations”). This definition utilizes a facts-and-circumstances test for determining when business is actively conducted, but provides that a corporation generally will only be in the active conduct of a trade or business if its officers and employees carry out substantial managerial and operational activities. Although incidental activities can be carried out on behalf of the foreign corporation by independent contractors, the activities of independent contractors are disregarded for purposes of determining whether the foreign corporation is engaged in the active conduct of a trade or business. Furthermore, while the 367 Active Conduct Regulations explicitly permit the activities of officers and employees of related entities to be considered in determining whether a corporation is in the active conduct of a trade or business, the Proposed 1297 Regulations do not permit consideration of the activities of officers and employees of related entities in the determination of whether an offshore reinsurer is a PFIC.

The Proposed 1297 Regulations define the term “insurance business” 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 offshore reinsurer. For these purposes, investment activities will be considered required to support or substantially related to insurance and annuity contracts issued or reinsured to the extent that income from the activities is earned from assets held by the offshore reinsurer to meet obligations under the contracts. The preamble to the Proposed 1297 Regulations acknowledges that a methodology to determine the portion of assets held to meet obligations under insurance and annuity contracts has not yet been determined; comments are requested on how this determination should be made. However, the preamble suggests that the test could be based on a specified percentage of the offshore reinsurer’s total insurance liabilities for the year.

Although legislative proposals introduced would have defined the Active Conduct Exception with reference to the offshore reinsurer’s reserve levels and premium income, the Proposed 1297 Regulations impose no requirement relative to the level of reserves or the amount of premium income necessary for an offshore reinsurer to be eligible for the Active Conduct Exception.

Consistent with prior industry positions on this issue, we note that the preamble to the Proposed 1297 Regulations does clarify that any offshore reinsurer that is treated as an insurance company for U.S. tax purposes (i.e., is taxable under subchapter L of the Code as an insurance company) is necessarily predominantly engaged in an insurance business for purposes of the statutory test.

The Proposed 1297 Regulations raise many difficult interpretive issues that could affect hedge fund reinsurer structuring, and that extend beyond the hedge fund reinsurer context. For example:

- What test would be applied to determine whether someone is acting in the capacity of an officer or employee of the offshore reinsurer? Would a leased or seconded employee of an offshore reinsurer suffice? How would an insurance management arrangement be treated if the employees of the insurance manager are named officers of, or leased employees to, the offshore reinsurer, and would the degree of control by officers and employees of the offshore reinsurer over the insurance manager employees matter?

Treasury Department and IRS Release Proposed Regulations Clarifying Application of PFIC Analysis to Offshore Reinsurers

Continued

- As the Proposed 1297 Regulations treat investment activity as part of the insurance business to the extent such activities are required to support or are substantially related to the issuance of insurance, annuity or reinsurance contracts, what degree of control must the officers and employees of the offshore reinsurer exercise over an investment manager that invests substantially all of the offshore reinsurer's assets pursuant to a multiyear contract to satisfy the Active Conduct Exception?
- What tax policy objective is served by altering the 367 Active Conduct Regulations definition of "active conduct" to exclude officers and employees of related entities for purposes of the Proposed 1297 Regulations?
- What impact will the Proposed 1297 Regulations have on offshore captive insurers and segregated cell companies?
- What impact will the Proposed 1297 Regulations have on an offshore catastrophe reinsurer in a year in which reserves are relatively low?

Many of these issues could be avoided if the Proposed 1297 Regulations adopted a more objective test as found in other areas of the tax law, rather than the Section 367 Active Conduct Regulations test requiring an offshore reinsurer to have its own officers and employees, a test which was designed to ensure that transfers of appreciated assets outside the United States were undertaken for sound business reasons and not purely for tax avoidance. The legislative history of the Active Conduct Exception indicates a congressional concern over abuse of this exception by overcapitalized offshore reinsurers that generate investment income in excess of the reasonable needs of its insurance business, and this concern could be addressed without resorting to the 367 Active Conduct Regulations test.

The Treasury Department has requested public comments on all aspects of the Proposed 1297 Regulations. Comments are due 90 days from April 24, 2015, the date the regulations are scheduled to be published in the Federal Register. Because the Proposed 1297 Regulations raise a multitude of issues, we expect that many substantive comments will be submitted.

If you have any questions regarding this memorandum, please contact Arthur J. Lynch (212 728-8225, alynch@willkie.com), Richard L. Reinhold (212 728-8292, rreinhold@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

April 24, 2015

Copyright © 2015 Willkie Farr & Gallagher LLP.

This memorandum is provided by Willkie Farr & Gallagher LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum may be considered advertising under applicable state laws.

WILLKIE FARR & GALLAGHER_{LLP}