

Proposed Regulations Address the PFIC Status of Foreign Insurance Companies

On April 23, 2015, Treasury and the Internal Revenue Service (IRS) issued proposed regulations (REG-108214-15) clarifying the scope of Internal Revenue Code section 1297(b)(2)(B) and inviting comments.

Background

Treasury and the IRS are aware that US investors have structured capital investments in hedge funds through foreign insurance companies.¹ The proposed regulations clarify the circumstances under which certain investment income of a foreign insurance company is excluded from the definition of passive income under section 1297(b)(2)(B). As a result, the proposed regulations indirectly address the passive foreign investment company (PFIC) status of such foreign insurance companies and the US federal income tax consequences to US investors in such arrangements.

Section 1297(b)(2)(B) provides that, except as provided in regulations, the term “passive income” does not include any income derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L as an insurance company if the corporation were a domestic corporation. The terms “active conduct” and “insurance business” are not defined in section 1297. In the absence of guidance, commentators have argued, and some taxpayers have taken the position, that the insurance company exception in section 1297(b)(2)(B) does not require the insurer to internally conduct all operational aspects of the insurance business. Because the PFIC exception does not appear to require conformity with the definitional requirements of “active conduct of a trade or business” contained in section 367(a) and Treas. Reg. § 1.367(a)-2T(b)(3), there appears to be flexibility in how the operation of such a venture may be structured.² It has become fairly common for foreign insurance companies to outsource substantial management and operational functions to independent service providers.

Definition of “active conduct”

The proposed regulations provide that the term “active conduct” has the same meaning as in Treas. Reg. § 1.367(a)-2T(b)(3) (the active conduct requirement), except that officers and employees are not considered to include the officers and employees of related entities. The active conduct requirement provides, among other things, that a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities.

¹ See, e.g., Notice 2003-34, 2003-1 C.B. 990 (May 9, 2003).

² See, e.g., Richard J. Safranek & Diana B. Chapman, Restrictive Regs May Threaten Insurance Company Exception to PFIC Rules, 13 INS. TAX REV. 1147 (July 1997).

Definition of “insurance business”

The proposed regulations define the term “insurance business” to mean the business activity of issuing insurance or annuity contracts and the reinsurance 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 by the foreign insurance company. The regulations generally define investment activity as any activity that produces income defined in section 954(c) (pertaining to foreign personal holding company income) and further provide that investment activities must support, or be substantially related to, insurance contracts issued or reinsured by the foreign corporation to the extent that income from the investment activities is earned from assets held by the foreign corporation to meet obligations under such contracts.

Comments requested

Treasury and the IRS have requested comments on all aspects of the proposed rules and have specifically requested comments regarding how to determine the portion of a foreign insurance company's assets that are held to meet obligations under insurance contracts issued or reinsured by the company.

Proposed effective/Applicability date

The regulations are proposed to apply on the date of publication of the Treasury decision adopting these rules as final regulations.

Observations

The use of foreign insurance companies as hedge fund vehicles has also attracted attention in Congress. Both then-Chairman of the House Ways and Means Committee Dave Camp and then-Senator Max Baucus introduced proposals in 2013-2014 that would narrow the insurance company exception to the PFIC rules by defining more precisely the relationship between a foreign insurance company's assets and insurance liabilities. Under both proposals, more than 50 percent of the foreign insurance company's gross receipts for a taxable year must consist of insurance premiums, and applicable insurance liabilities must constitute more than 35 percent of total assets.

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