Article from
Taxing Times
February 2020

Treasury Issues Proposed Rules for Determining Active Income of Certain Foreign Insurance Companies

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On July 11, 2019, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") released REG-105474-18, Guidance on Passive Foreign Investment Companies (the "Proposed Regulations"). The Proposed Regulations provide guidance for determining whether the activity of certain foreign corporations is excepted from the Passive Foreign Investment Company ("PFIC") regime through the active conduct of an insurance business exception of Internal Revenue Code ("I.R.C.," the "Code") § 1297(b)(2)(B).[1] The Proposed Regulations withdraw the proposed regulations issued April 24, 2015[2] ("the 2015 Proposed Regulations"). The Proposed Regulations were issued in response to changes to the PFIC rules under the Tax Cuts and Jobs Act (Pub. L. No. 115-97) ("TCJA"), specifically, enactment of § 1297(f), which defines a "qualifying insurance corporation" for purposes of the active conduct exception.[3]

This article provides a brief historical background on the PFIC rules and summarizes the insurance-relevant portions of the Proposed Regulations, as well as the issues and concerns raised in industry comments solicited under the Proposed Regulations.

BACKGROUND

The PFIC regime was introduced to prevent U.S. persons from obtaining indefinite deferral of U.S. tax on investment income earned through investments in foreign corporations primarily engaged in passive investing activities. Under the PFIC rules, certain minority U.S. shareholders of foreign entities deemed to be passive investment vehicles must pay tax—or interest on tax that would otherwise be owed—on "excess" distributions and any gain on disposal of their interest in the PFIC. Certain elections are available to taxpayers to immediately include PFIC income or unrealized appreciation of PFIC stock in U.S. taxable income rather than incur punitive tax and interest charges resulting from deferring U.S. taxation until earnings are distributed or the stock is disposed. Given the large amount of seemingly passive investments that most insurance companies hold to pay out claims, the PFIC rules could cause U.S. investors in foreign insurance companies to be treated as owning a PFIC interest, despite such companies not being mere passive investment vehicles. To prevent this result, the Code provides an exception to the PFIC regime for investment income "derived in the active conduct of an insurance trade or business" by a company predominantly engaged in an insurance business that would be taxable as an insurance company were it a domestic corporation.[4] The IRS and Treasury issued the 2015 Proposed Regulations to provide guidance as to what types and level of activities would satisfy the active conduct requirements, but the proposed guidance was never finalized.

The TCJA introduced additional statutory hurdles to qualification under the active insurance exception, primarily through the requirement that any corporation satisfying the exception must be a Qualifying Insurance Corporation ("QIC") as defined in newly added I.R.C. § 1297(f).[5] Pursuant to § 1297(f), for a corporation to qualify as a QIC, its "applicable insurance liabilities" must exceed 25 percent of its total assets as reported on the corporation's "applicable financial statement" for its most recent year.[6] The Code's definition of applicable insurance liabilities differs from the common conception of insurance liabilities within the insurance industry, defining them narrowly as "loss and loss adjustment expenses" and "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."[7] Notably, this definition excludes unearned premium reserves and other liabilities commonly carried by insurance companies in their capacity as insurers from the definition. The Code establishes an alternative test that lowers the liability threshold from 25 percent to 10 percent for taxpayers whose failure to satisfy the 25 percent standard is "due solely to runoff-related or rating-related circumstances involving such insurance business."[8]

Section 1297(f) limits insurance liabilities for the purpose of either test to the lesser of (1) the amount reported to the "applicable regulatory body" in the applicable financial statement, (2) the amount required by law or regulation or (3) as otherwise determined by regulations prescribed by the Secretary.[9] An applicable financial statement refers to, in descending order, generally accepted accounting principles ("GAAP") financials, IFRS financials or the local insurance annual statement. If a company prepares more than one of these reports, the first listed is deemed to be "applicable."[10] An applicable insurance regulatory body is defined as "the entity established by law to license, authorize, or regulate such business" and to which the applicable financial statement is provided.

THE PROPOSED REGULATIONS

The Proposed Regulations contain several new provisions relevant to the PFIC active conduct exception. These changes can be thought of in three broad categories:

1. regulations defining the active conduct of an insurance trade or business, including the introduction of the new "active conduct percentage" test;

2. rules clarifying the requirements for qualification as a QIC; and

3. other changes to the PFIC insurance regime.

Each of these three categories will be addressed in turn.[11]

Active Conduct and the Active Conduct Percentage Test

The most significant change in the Proposed Regulations was the introduction of the all-or-nothing "active conduct percentage" test. The test is expected to make it significantly more difficult for insurance companies to avoid PFIC categorization and was met with a largely negative response from commenters. The test measures the ratio of personnel costs incurred by employees of the QIC (and certain related companies) relative to total personnel costs. If the active conduct percentage is 50 percent or greater, all income of the QIC is deemed to be active. If the active conduct percentage is below 50 percent, all income of the QIC is deemed passive.[12] The active conduct rule provides that the personnel costs of a related company may be included in the numerator of the 50 percent test, provided a three-prong control test is satisfied.[13]

The numerator of the active conduct percentage is the aggregate amount of expenses for services of the officers and employees of the QIC (or eligible related entities) related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance contracts entered into by the QIC, including amounts reasonably allocated thereto.[14] The denominator is essentially defined as the numerator plus analogous costs paid to persons that are not employees of the QIC or a related company.[15]

The bright-line active conduct test marks a significant departure from the 2015 Proposed Regulations. Under those rules, the determination of whether an insurance company participated in an active trade or business was made under a generalized facts and circumstances test. The drafters of the new Proposed Regulations indicated that a bright-line test related to personnel costs was appropriate, as the percentage of activities performed by employees of the QIC (or related companies) is a reasonable proxy for how actively the QIC engages in the insurance business.[16]

The Proposed Regulations inclusion of the officers and employees of related entities for the purposes of the active conduct test represents an expansion of potential service providers from the 2015 Proposed Regulations, which contemplated only employees of the entity itself in the active conduct analysis.[17] A three-part test must be satisfied for this purpose:

1. **Ownership.** Either the QIC must own 50 percent of the vote and value (for a corporation) or capital and profits interest (for a partnership) of the entity, or more than 80 percent of the vote and value or capital and profits interest of both the QIC and the related entity must be owned by a common parent.[18]

2. **Oversight and supervision.** The QIC must exercise regular oversight and supervision over the services performed.[19]

3. **Payment.** The QIC must either (1) directly pay all the compensation of the other entity's officers and employees attributable to the insurance services, (2) reimburse the other entity for the portion of its expenses with a profit markup as appropriate or (3) pay arm's length compensation on a fee-related basis to the other entity for the insurance services provided.[20]

QIC Clarifications

Aside from the active conduct percentage test, the Proposed Regulations provide several additional rules and clarifications defining what kind of corporation constitutes a QIC.

Similar to the Code itself, the Proposed Regulations deviate from common industry parlance in defining applicable insurance liabilities. The Proposed Regulations define applicable insurance liabilities as the sum of "[o]ccurred 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," "unpaid expenses . . . of investigating and adjusted unpaid losses" described previously and "[t]he

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."[21] Total assets are defined as "the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its applicable financial statement for the last annual accounting period ending with or within the taxable year."[22]

The Proposed Regulations further provide that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement; (2) the minimum amount required by the applicable insurance regulatory body; and (3) the amount shown on the most recent U.S. GAAP or IFRS financials, provided such financials were not prepared for financial reporting purposes.[23] To the extent that a financial statement not prepared under GAAP or IFRS does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either U.S. GAAP or IFRS.[24] An anti-abuse rule is provided whereby a foreign corporation that ceases to prepare financials in accordance with its applicable method absent a non-tax business purpose will be treated as having no applicable insurance liabilities for purposes of the QIC test.[25]

Taxpayers that fail to satisfy the 25 percent test may still qualify as a QIC under an alternative facts and circumstances test, provided that applicable insurance liabilities constitute more than 10 percent of the company's total assets, the corporation is predominantly engaged in an insurance business and the failure to satisfy the 25 percent test is due solely to runoff-related or rating-related circumstances. The same definitions and limitations that apply to the 25 percent test similarly apply to the 10 percent test.[26] In this section, the Proposed Regulations provide clarity as to what constitutes being "predominantly engaged in the insurance business" and what constitutes runoff and ratings-related circumstances, as well as providing procedures for making the alternative test election.

The Proposed Regulations provide factors to be considered when determining whether a company is predominantly engaged in an insurance business as well as specific patterns that would cut against such a finding.[27] Facts and circumstances to be considered include claims payment patterns, loss exposure of the company, percentage of gross receipts constituting premiums and the number and size of insurance contracts of the foreign corporation. Examples of facts that cut against such a finding include a small number of insured risks with low likelihood of occurrence but large potential costs, employees and agents focused to a greater degree on investment activities, and low loss exposures.

With regard to runoff-related circumstances, the Proposed Regulations indicate that a company seeking this status must have adopted a plan of liquidation or termination under the supervision of the company's regulator to qualify for this status—a narrow reading of the insurance concept of runoff.[28] A company is deemed to satisfy the rating-related circumstances if "[t]he 25 percent test is not met as a result of the specific requirements with respect to capital and surplus that a generally recognized credit rating agency imposes" and it "complies with the requirements of the credit rating agency in order to maintain the minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year."[29]

The Proposed Regulations also provide procedures that foreign corporations must follow to qualify for the alternative facts and circumstances test, as well as the procedures U.S. persons must undertake to make such an election. Under these rules, a foreign corporation must provide the owner a statement or release a public statement indicating they satisfy the alternative test and the U.S. person must obtain information from the foreign corporation proving as much prior to making the election.[30] To elect qualification under the alternative facts and circumstances standard prior to the regulations being finalized, the U.S. person must file a limited-information Form 8621.[31]

Other Provisions

Other notable provisions of the Proposed Regulations include the following:

- **Timing.** The Proposed Regulations apply prospectively (*i.e.*, to taxable years beginning on or after final regulations are published in the Federal Register). Prior to finalization, taxpayers may apply the rules as if they were final, provided they are applied consistently.[32]

- **Definition of insurance business and investment activities.** The Proposed Regulations define an insurance business as the business of issuing insurance and annuities or reinsuring risks underwritten by other insurance companies (or both).[33] The definition also includes the investment activities and administrative services required to support those insurance contracts.[34] Investment activities are any activities that generate income from assets to meet the QIC's insurance obligations.[35]

- **Treatment of income and assets of look-through subsidiaries and look-through partnerships held by a QIC.** The Proposed Regulations provide that certain items of income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a QIC.[36] Generally, if income or assets are passive

in the hands of a look-through entity, they are treated as passive.[37] However, the income and assets of a QIC are tested to determine if they qualify for the insurance exception. The assets and liabilities of the look-through entity must be included in the applicable financial statement of the foreign corporation for purposes of the 25 percent test and 10 percent test for this rule to apply.[38]

- **Qualifying Domestic Insurance Corporations.** Income and assets of Qualifying Domestic Insurance Corporations ("QDICs") are not treated as passive.[39] A QDIC is a domestic corporation that is subject to tax as an insurance company under Subchapter L and is subject to Federal income tax on its net income. This rule is intended to address certain structures where a tested foreign corporation owns a domestic insurance corporation.

- **No double counting.** Nothing permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25 percent test and the 10 percent test).[40]

INDUSTRY COMMENTS

The IRS and Treasury solicited comments on a variety of issues addressed in the Proposed Regulations and received roughly two dozen comment letters.[41] These fall into a few broad categories:

- **Active conduct.** Response to the new active conduct rules, particularly the active conduct percentage test, was largely negative. Numerous commenters called for the outright elimination of the test or relegation of the test to a safe harbor in the final regulations. The Reinsurance Association of America ("RAA") commented that "[t]he percentage test places excessive emphasis on the size of staff, while excluding costs of essential functions routinely performed by independent agents, brokers, and investment advisors, and has little bearing on the key metric of an insurance company, which is the assumption of insurance risk. This distorted measurement could result in well established companies being improperly classified as PFICs and should be deleted." The American Bar Association ("ABA") highlighted definitional ambiguities in the regulations, unreasonable compliance burdens for U.S. shareholders and the harsh cliff effect of an all-or-nothing test in calling for the elimination of the active conduct percentage test. The ABA proposed that if the test is retained, final regulations should include an alternative facts and circumstances test that could be satisfied by a showing that the failure to meet the 50 percent threshold is driven by "any practical business reason." Other commenters, including the American Council of Life Insurers ("ACLI"), support retaining the test only as a safe harbor, with a facts and circumstances determination serving as the general test.

    - **Related parties.** Commenters indicated that the inclusion of related parties in the active conduct analysis represented an improvement from the 2015 Proposed Regulations. However, some called for the definition to be expanded to include activities of third parties while others called for revisions to the three-pronged control test included in the Proposed Regulations.

- **Alternative test.** Numerous commenters requested revisions to the Proposed Regulations addressing "rating-" or "runoff-" related circumstances to provide clarity and to ensure the regulations more closely adhere to commonly accepted industry understanding of those situations. Several commenters requested that deemed or automatic elections be made in the case of de minimis or minority shareholders to lessen the compliance burden on such shareholders under certain circumstances.

- **Issues regarding Applicable Insurance Liabilities.**

    - **Terminology and the definition of loss.** Several commenters requested clarifications of the definition of losses as defined in the Proposed Regulations. In particular, commenters disapprovingly noted the use of the undefined, non-industry term "occurred losses" and recommended substituting the term "unpaid loss" as defined in § 832. Several commenters similarly recommended aligning the definitions of losses and related expenses in the regulations with those already included either in Subchapter L of the Code or with respect to GAAP, IFRS or insurance financial statements.

    - **Limitations on reserves.** A number of commenters also suggested changes or clarifications regarding limitations on reserves as set out in the Proposed Regulations. For example, several commenters expressed concern with the relatively vague requirements surrounding the mandatory discounting of reserves that are not discounted "on an economically reasonable basis" on the applicable financial statement.

- **Applicable financial statements.** The ABA called for the removal of the rules referencing financial statements prepared for other than "financial reporting purposes" and disallowing a taxpayer from changing their method of accounting absent a non-tax business purpose. A few commenters objected to the rule, which provides that the assets and liabilities of a look-through subsidiary can be considered only if they appear on the applicable financial statement of a QIC.

- **Qualifying Domestic Insurance Corporations.** A number of commenters, including the ABA, ACLI and RAA, called for changes to the QDIC rules that may cause foreign companies that would not otherwise be treated as PFICs to become PFICs.

- **Interplay with I.R.C. § 954(i).** A number of commenters suggested that the regulations should be revised to provide that income from an active insurance business that is excepted from foreign personal holding company income ("FHPCI") under § 954(i) should apply in addition to the insurance exception under § 1297(b)(2)(B).

- **Timing.** Several commenters called for delaying the mandatory implementation of the rules beyond the date the final regulations are published in the Federal Register due to the complexity and uncertainty surrounding the rules.

WHAT'S NEXT?

The IRS canceled a public hearing on the Proposed Regulations scheduled for Dec. 9, 2019, as no public commenters requested the opportunity to speak. There is no current publicly announced timeline for the issuance of revised or finalized PFIC regulations. In their comments, the ABA took the unusual step of recommending that the IRS and Treasury consider issuing a second round of proposed regulations "due to the number and complexity of the issues addressed in the Proposed Regulations." Given this recommendation and the sheer breadth and depth of comments from other interested parties, it may be some time before final PFIC guidance is issued. ■

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ENDNOTES

1 References to the I.R.C. or the Code are to the Internal Revenue Code of 1986, as amended through the date of this writing.

2 REG-108214-15.

3 "An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97, enacted Dec. 22, 2017.

4 See current and former I.R.C. § 1297(b)(2)(B).

5 I.R.C. § 1297(b)(2)(B).

6 I.R.C. § 1297(f)(1)(B).

7 I.R.C. § 1297(f)(3)(A).

8 I.R.C. § 1297(f)(2).

9 I.R.C. § 1297(f)(3)(B).

10 I.R.C. § 1297(f)(4)(A).

11 The Proposed Regulations also made changes to certain non-insurance provisions that are beyond the scope of this article.

12 Prop. Reg. § 1.1297-5(c)(1).

13 Prop. Reg. § 1.1297-5(c)(3)(ii).

14 Prop. Reg. § 1.1297-5(c)(4)(i)(A).

15 The Proposed Regulations indicate that ceding commissions should not be included in the numerator or the denominator.

16 Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297, & 1298) at 33135.

17 *Id.*

18 Prop. Reg. § 1.1297-5(c)(3)(ii)(A).

19 Prop. Reg. § 1.1297-5(c)(3)(ii)(B).

20 Prop. Reg. § 1.1297-5(c)(3)(ii)(C).

21 Prop. Reg. § 1.1297-4(f)(2).

22 Prop. Reg. § 1.1297-4(f)(7).

23 Prop. Reg. § 1.1297-4(e). See discussion of § 1297(f) under Background for ordering rules for applicable financial statements.

24 Prop. Reg. § 1.1297-4(e)(3).

25 Prop. Reg. § 1.1297-4(e)(4).

26 Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33134.

27 Prop. Reg. § 1.1297-4(d)(2).

28 Prop. Reg. § 1.1297-4(d)(3).

29 Prop. Reg. § 1.1297-4(d)(4).

30 Prop. Reg. § 1.1297-4(d)(5).

31 *Id*.

32 Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33161.

33 Prop. Reg. § 1.1297-5(c)(2).

34 *Id.*

35 Prop. Reg. § 1.1297-5(h)(2).

36 Prop. Reg. § 1.1297-5(f).

37 Guidance on Passive Foreign Investment Companies, 84 Fed. Reg. 33120 (July 11, 2019) (to be codified at 26 C.F.R. pts. 1291, 1297 & 1298) at 33135.

38 Prop. Reg. § 1.1297-5(f)(2).

39 Prop. Reg. § 1.1297-5(d) and Prop. Reg. § 1.1297-5(e)(2).

40 Prop. Reg. § 1.1297-5(g).

41 Comments regarding non-insurance changes in the Proposed Regulations are beyond the scope of this article.