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PROPOSED REGULATIONS TARGETING HEDGE FUND REINSURANCE ARRANGEMENTS MAY IMPACT TRADITIONAL INSURANCE COMPANIES

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On April 24, 2015, Treasury and the Internal Revenue Service (IRS) published proposed regulations (REG-108214-15) that provide guidance regarding when a foreign insurance company's income is excluded from the definition of passive income under Section 1297(b)(2)(B).[1] As described in the preamble, the proposed regulations are directed at hedge funds that purport to establish a foreign reinsurance company in an effort to avoid treatment as a passive foreign investment company (PFIC). The issuance of the proposed regulations met a 90-day deadline for additional guidance on this issue that IRS Commissioner John Koskinen agreed to early this year during questioning by Senator Ron Wyden (D-OR).[2] It is unclear when final regulations might be issued, but the issue addressed by the proposed regulations is of great interest to Senator Wyden who will presumably continue to prod Treasury and the IRS to act to curtail use of the PFIC insurance exception by hedge funds. The insurance industry is well advised to monitor developments in this area and provide input to prevent government actions that could have unintended consequences.

BACKGROUND

The PFIC rules are an anti-deferral regime intended to ensure that U.S. persons cannot avoid current U.S. income tax on their share of passive or highly mobile income by investing through a foreign corporation.[3] If a U.S. person is a shareholder in a PFIC, that person is subject to U.S. tax on its share of the PFIC's income under one of three alternative regimes: (1) an interest-charge regime; (2) an elective full-inclusion regime; or (3) an elective mark-to-market regime.

A foreign corporation is a PFIC if either 75 percent or more of its gross income for the taxable year is passive income (passive income test), or an average of 50 percent or more of its assets produce passive income or are held for the production of passive income (passive asset test). For purposes of applying the passive income test, Section 1297 provides that the term "passive income" does not include any income that is derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L as an insurance company if the corporation were a domestic corporation.

In 2003, the IRS issued Notice 2003-34 to address certain arrangements in which taxpayers were deferring recognition of ordinary income or characterizing ordinary income as capital gain as a result of an investment in a foreign company that was a purported insurance company.[4] The foreign company would invest in hedge funds or investments in which hedge funds typically invest. The IRS noted that to qualify as an insurance company for federal tax purposes, a taxpayer must issue insurance contracts and must use its capital and efforts primarily in earning income from issuing such contracts. The IRS stated that it would scrutinize the types of arrangements described in the Notice and apply the PFIC rules in those cases in which the IRS determines the foreign company is not an insurance company for federal tax purposes.

On June 12, 2014, Senator Wyden sent a letter to Treasury and the IRS asking them to outline the actions they have taken to address the types of transactions described in Notice 2003-34. Senator Wyden also asked Treasury and the IRS whether they believe they need any additional authority from Congress to address the issue. On Aug. 8, Treasury responded that it has in fact scrutinized the arrangements described in Notice 2003-34. Treasury stated, however, that it can be difficult to determine whether a foreign corporation is an active reinsurance company or a passive investment vehicle. Treasury noted that there is no statutory, objective test to apply. In addition, such a determination necessarily involves consideration of the appropriate level of reserves required to satisfy future insurance claims, which in turn may depend on the nature of the risks being insured and the riskiness of the assets in which the reserves are invested.

Treasury's letter prompted Senator Wyden to respond that while there may not be a bright line, he is "concerned that under current tax administration practices and constraints there isn't any line at all."[5] He also released a report on the hedge fund insurance issue that was prepared by the Joint Committee on Taxation (JCT) at his request.[6] The JCT report provides background on the issue, a description of legislative proposals to address the issue that were made by Representative Dave Camp (R-MI) and Senator Max Baucus (D-MT) in connection with tax reform efforts, and background and data on offshore reinsurance generally and in Bermuda specifically.[7] Senator Wyden's letter noted that the JCT report identifies at least two U.S. hedge-fund-backed reinsurance companies that had insurance liability-to-asset ratios of only 1 percent in 2012. Senator Wyden also questioned whether companies with such low ratios could be considered predominantly engaged in the reinsurance business.

Treasury responded to Senator Wyden on Oct. 21, 2014.[8] Treasury stated that it had conducted an in-depth review of the Camp and Baucus proposals and discussed them with various stakeholders. Based on that review, Treasury expressed concern that those proposals could be both over-inclusive, because a significant percentage of legitimate insurance companies would fail to satisfy the tests, and under-inclusive, because the tests could be manipulated by reinsurance companies acting in concert. Treasury concluded by stating it was working with the IRS and interested stakeholders to identify regulatory approaches that could be tailored to address inappropriate arrangements with objective rules.

On Feb. 3, 2015, Commissioner Koskinen testified in a Senate Committee on Finance hearing on "Internal Revenue Service Operations and the President's Budget for Fiscal Year 2016." During that hearing, Senator Wyden noted that the IRS had failed to release definitive guidance on the hedge fund reinsurance issue after it issued Notice 2003-34. Senator Wyden secured Commissioner Koskinen's commitment that the IRS would try to release new guidance within 90 days. As noted above, that guidance came on April 24 in the form of proposed regulations.[9]

THE PROPOSED REGULATIONS

The proposed regulations clarify the circumstances under which investment income earned by a foreign insurance company is "derived in the active conduct of an insurance business" by defining the terms "active conduct" and "insurance business" for purposes of Section 1297. "Active conduct" is defined to have the same meaning as in Temp. Treas. Reg. § 1.367(a)-2T(b)(3), except that officers and employees do not include the officers and employees of related entities. Temp. Treas. Reg. § 1.367(a)-2T(b)(3) provides that a corporation actively conducts a business only if officers and employees of the corporation and related entities carry out substantial managerial and operational activities. The proposed regulations define "insurance business" to mean the business activity of issuing insurance and 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 proposed regulations further provide that an "investment activity" is any activity engaged in to produce income of a kind that would be foreign personal holding company income as defined in Section 954(c), and that investment activities will be treated as required to support or as substantially related to insurance or annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contract.

Treasury and the IRS requested comments by July 23, 2015, on all aspects of the proposed regulations, and specifically on appropriate methodologies for determining the extent to which assets are "held to meet obligations under insurance and annuity contracts." The preamble suggests one approach would be to treat assets as held to meet insurance obligations "to the extent the corporation's assets in the calendar year do not exceed a specified percentage of the corporation's total insurance liabilities for the year." The preamble asks for comments on what percentage would be appropriate under this method as well as suggestions for other methods that would be more appropriate.

ISSUES RAISED

The proposed regulations are intended to target hedge fund insurance companies. Nevertheless, "traditional" insurance or reinsurance companies could be affected. There are at least two areas that merit attention by such companies: (1) the narrow definition of active conduct; and (2) the method for determining what portion of assets are passive rather than active.

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As noted above, the proposed regulations do not consider officers and employees of related entities in the "active conduct" determination. The proposed regulations offer no explanation for this narrowing of the Temp. Treas. Reg. § 1.367(a)-2T(b)(3) definition in the case of insurance companies. This restrictive definition appears to ignore how many traditional insurance groups operate. It is quite common for traditional insurance groups to centralize certain activities, such as underwriting, investment management and claims management, for non-tax reasons. Without the ability to consider these activities, many traditional insurance companies that do not present the same tax avoidance concerns as hedge fund reinsurers may be unable to meet the active conduct definition (at least not without restructuring their business operations solely for tax reasons).

It is interesting to note that when Treasury issued proposed regulations governing a similar exception to the PFIC rules for banks, it defined active conduct by cross-reference to Temp. Treas. Reg. § 1.367(a)-2T(b)(3) without modification.[10] That definition seems eminently reasonable as banks, like insurance companies and many other types of business enterprises,

CONTINUED ON PAGE 42

often rely on the services of related entities to conduct their business operations. And yet Treasury has proposed rules for insurance companies that ignore that business reality.

The second aspect of the proposed regulations that traditional insurance companies should consider is the request for comments on how to determine the portion of assets that are passive versus active (i.e., held to meet insurance obligations). No method is provided, making it difficult to know what Treasury thinks would be appropriate on this critical issue. The preamble does suggest one possible approach—treat assets as held to meet insurance obligations to the extent they do not exceed a specified (but currently unstated) percentage of the corporation's total insurance liabilities for the year. The proposed regulations do not explain why they do not include a specific method, but presumably Treasury recognized how challenging it is to identify a test that will work for all insurance companies. The amount of capital an insurance company needs depends on many factors, including the types and amounts of coverage it writes, the types of investment assets it holds, and other regulatory and rating agency requirements. In addition, companies in different stages of the business lifecycle (for example, start-up, expansion or runoff) have different capital needs.

Similar to the method suggested in the preamble, Representative Camp and Senator Baucus both proposed a bright-line test in their tax reform proposals that would look at whether a company's insurance liabilities constitute more than 35 percent of its assets. Senator Wyden's recent "Offshore Reinsurance Tax Fairness Act" suggests a three-part test. Under that test, if insurance liabilities are less than 10 percent of assets, the company is not an insurance company. If insurance liabilities are greater than 25 percent of assets, the company is an insurance company. If insurance liabilities are between 10 and 25 percent of assets, then a facts and circumstances test applies. While this approach provides more flexibility than a one-size-fits-all approach, and is certainly an improvement over the Camp and Baucus approach, it nevertheless is a blunt tool. As such, it risks being both over- and under-inclusive.

Whatever approach is ultimately taken by Treasury and the IRS on this point could be of significance to traditional insurance or reinsurance companies, particularly those that underwrite catastrophic risks, are in a start-up phase, or are in runoff. ■

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END NOTES

[1] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.

[2] Press Release, Senate Committee on Finance, Wyden Recognizes Administration for Responding to His Push to Address Offshore Reinsurance Tax Loophole (April 23, 2015).

[3] Sections 1291–1298.

[4] 2003-1 C.B. 990.

[5] Letter from Senator Ron Wyden, Chairman, Senate Committee on Finance, to Jacob J. Lew, Secretary, Department of the Treasury (Sept. 11, 2014).

[6] Joint Committee on Taxation, *Background and Data with Respect to Hedge Fund Reinsurance Arrangements* (July 31, 2014).

[7] The Camp and Baucus proposals are similar and would both replace the "predominantly engaged in an insurance business" test with a gross receipts test. Under the gross receipts test: (1) more than 50 percent of the controlled foreign corporation's (CFC's) gross receipts for the taxable year must consist of premiums for insurance or reinsurance; and (2) the CFC's applicable insurance liabilities must constitute more than 35 percent of the CFC's total assets as reported on its applicable financial statements for the year.

[8] Letter from Alastair M. Fitzpayne, Assistant Secretary for Legislative Affairs, Department of the Treasury, to Senator Ron Wyden, Chairman, Senate Committee on Finance (Oct. 21, 2014).

[9] On June 25, 2015, Senator Wyden introduced S. 1687, the "Offshore Reinsurance Tax Fairness Act." The bill would provide a bright-line test for determining whether a company is an insurance company for purposes of applying the insurance exception to the PFIC rules. Under the new test, if a company's insurance liabilities exceed 25 percent of its assets, it would be considered an insurance company for purposes of applying the exception. If insurance liabilities are between 10 and 25 percent of assets, a facts and circumstances test would apply. If insurance liabilities are less than 10 percent of assets, the company could not qualify as an insurance company and thus could not qualify for the PFIC exception.

[10] Prop. Treas. Reg. § 1.1296-4(f)(1).