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Final and Proposed Regulations on PFIC Rules Provide Helpful Clarifications for Insurers

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The Treasury and the IRS have released final regulations (the "Final Regulations") and proposed regulations (the "2020 Proposed Regulations") relating to passive foreign investment companies ("PFICs"). The Final Regulations and the 2020 Proposed Regulations provide guidance on the PFIC insurance company exception as well as general guidance on the application of the PFIC rules. The 2020 Proposed Regulations affecting insurance companies generally are an improvement over regulations proposed in 2019 (the "2019 Proposed Regulations"), particularly in defining the active insurance exception to PFIC treatment. However, insurers that rely to a significant degree on outsourcing in the conduct of their business may have difficulty avoiding PFIC treatment under the new rules.

The PFIC rules are intended to prevent U.S. taxpayers from deferring tax by holding passive investment assets through foreign corporations. In general, a foreign corporation is treated as a PFIC if at least 75% of its gross income is "passive income" (such as interest or dividends) or at least 50% of its assets are held for the production of passive income. If a corporation is treated as a PFIC, distributions from the corporation and gain from the disposition of stock of the corporation generally are taxed as ordinary income for U.S. shareholders and are subject to an interest charge.

The PFIC rules recognize that foreign insurance companies should not be treated as PFICs if the investment assets they hold and their investment income are part of an active insurance business. The 2017 Tax Cuts and Jobs Act ("TCJA") added the additional requirement that, in general, "applicable insurance liabilities" of the foreign insurance company represent more than 25% of its total assets.

The Final Regulations apply to U.S. investors' taxable years beginning on or after the publication of the rules in the Federal Register (potentially in 2021). The 2020 Proposed Regulations will not be effective until after they are finalized.

We summarize key changes made by the Final Regulations and the 2020 Proposed Regulations with a focus on considerations for the insurance industry.

Active Conduct of an Insurance Business

- The 2020 Proposed Regulations allow foreign insurers to meet a new factual requirements test or alternatively satisfy a modified version of the 50% bright-line numerical test for active conduct of an insurance business introduced in the 2019 Proposed Regulations.

Comment: Many commentators requested a facts-and-circumstances-based option for qualification, as opposed to the rigidity of a numerical test (particularly as the TCJA already included a “bright-line” test for applicable insurance liabilities).

Factual Requirements Test

- To satisfy the factual requirements test, a foreign insurer’s officers and employees must be involved in all levels of planning and implementation related to underwriting, investment, contract and claim management, and sales activities. They must perform virtually all of the active decision-making functions relevant to underwriting on a contract-by-contract basis.

- These required activities must be conducted by officers or senior employees with appropriate experience, who devote all (or virtually all) of their work to these activities and similar activities for related entities and work for the insurance company on a daily or other frequent basis.

Comment: Multinational insurance groups with significant in-house personnel may welcome the ability to rely on the factual requirements test and avoid running numerical tests based on U.S. tax rules. However, smaller insurance companies, particularly those that make significant use of external service providers, may find it difficult to satisfy this test.

50% Active Conduct Test

- To satisfy the 50% active conduct numerical test, costs incurred by the foreign insurer for officers’ and employees’ services with respect to core functions (other than investment activities) must equal at least 50% of the total costs for all services with respect to core functions (other than investment activities).

- Broker fees and ceding commissions for reinsurance contracts are not taken into account in determining whether the 50% active conduct test is satisfied.

- Any functions outsourced to an unrelated entity require robust oversight by the foreign insurer’s officers and employees.

Comment: The revisions to the 50% active conduct test provide welcome changes from the 2019 Proposed Regulations, particularly the new exclusions for payments to external investment managers and brokers, which are common even for large insurance groups.

New Per Se Exclusion Rules

- Under the 2020 Proposed Regulations, foreign insurers that have no employees (or a nominal number of employees) and rely exclusively (or almost exclusively) on independent contractors to perform their core functions are not engaged in the active conduct of an insurance business (even if they would otherwise pass the factual requirements test or the 50% active conduct test).

- A vehicle for securitizing or collateralizing insurance risks (e.g., a catastrophe bond issuer, sidecar or collateralized insurance vehicle) is ineligible for the active conduct exception if it is designed to provide an investment return tied to a predetermined portfolio of insurance risks or indices related to insurance risks.

Comment: Many traditional sidecar vehicles were already treated as PFICs by their sponsors. These rules, together with the revised active conduct tests, appear particularly focused on targeting insurance vehicles that are not seeking and evaluating new business with a team of in-house underwriters.

Related Entities

- Under both the factual requirements test and the 50% active conduct test, a foreign insurer's officers and employees include the officers and employees of related entities. Entities are generally considered related based on 50% common ownership of value and voting power by a non-U.S. parent corporation or partnership.

- The foreign insurer must bear the related entities' compensation costs on an arm's-length basis and exercise oversight and supervision over the services provided by the related entities' officers and employees.

Comment: The favorable treatment of employees of related persons is somewhat in tension with the TCJA's base erosion and anti-abuse tax ("BEAT"), which imposes a punitive minimum tax on reinsurance between U.S. companies and foreign related reinsurers.

Comment: Personnel employed by both the foreign insurer and a related or unrelated U.S. company are unlikely to help satisfy the factual requirements test because they generally will not work for the foreign insurer on a daily or other frequent basis. "Dual hat" employees may, however, help to satisfy the 50% active conduct test, but their roles must be carefully evaluated in light of the BEAT and U.S. trade or business rules.

25% Applicable Insurance Liabilities Test

- For a foreign insurer to qualify for the PFIC insurance company exception, it generally must have applicable insurance liabilities representing more than 25% of its total assets. Applicable insurance liabilities include loss and loss adjustment expenses, along with reserves for life and health insurance risks under contracts providing coverage for mortality or morbidity risks.

- The Final Regulations follow the 2019 Proposed Regulations in clarifying that although reserves for annuities with longevity risk may qualify, unearned premium reserves for property and casualty companies do not. The Final Regulations also clarify that reserves for guaranteed investment contracts, structured settlements or life insurance contracts, the reserves for which do not depend on life expectancy of the insured, are excluded.

- The preamble to the 2020 Proposed Regulations suggests that reserves for modified coinsurance transactions are insurance liabilities of the ceding company and not of the reinsurer. A foreign reinsurer therefore could not take advantage of liabilities reinsured on a modified coinsurance basis to satisfy the applicable insurance liability test.

  Comment: Treasury's view of modified coinsurance is consistent with the tax and statutory accounting for such transactions, where the reserves and assets supporting them are held on the ceding company's balance sheet. Foreign reinsurers should consider funds withheld arrangements, which do transfer reserve liabilities for tax purposes.

Domestic Subsidiaries

- The Final Regulations follow the 2019 Proposed Regulations in confirming that a foreign holding company can treat its indirect interest in the income and assets of a "qualifying domestic insurance company" as active for purposes of the PFIC tests.

- The Final Regulations retain the approach taken in the 2019 Proposed Regulations regarding the stock of U.S. corporations owned by a 25%-owned domestic subsidiary of a foreign corporation that is being tested for PFIC status. This rule, which under the Final Regulations applies in priority to the qualifying domestic insurance subsidiary rules, treats the U.S. stock owned by the 25%-owned domestic subsidiary as non-passive for purposes of the PFIC rules.

- The Final Regulations remove a much-criticized rule in the 2019 Proposed Regulations that required a U.S. shareholder of a foreign parent corporation that relied on a qualifying domestic insurance subsidiary to test the foreign parent's foreign subsidiaries for PFIC status separately from the parent corporation. The Final Regulations also remove a similar rule requiring testing of lower-tier subsidiaries in groups that benefited from favorable treatment of U.S. stock held through 25%-owned domestic subsidiaries.

  Comment: The removal of the rules for testing lower-tier entities is responsive to concerns of taxpayers that minority shareholders would be unable, as a practical matter, to evaluate lower-tier entities within a corporate group.

- The 2020 Proposed Regulations add a new rule to disincentivize foreign corporations from shifting passive assets into their U.S. subsidiaries. This rule scales back favorable treatment where the U.S. insurance company holds excessive investment assets when compared with total insurance liabilities (200% for life insurers, 400% for property and casualty insurers).

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Please do not hesitate to contact us with any questions.

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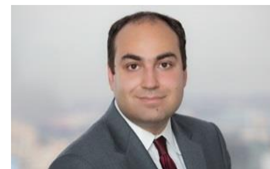
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