Client Update

IRS Issues Proposed Passive Foreign Investment Company (PFIC) Regulations for Non-U.S. Insurance Companies

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Today, the Internal Revenue Service ("IRS") published proposed regulations (the "Proposed Regulations") concerning the application of the passive foreign investment company ("PFIC") rules to certain non-U.S. insurance companies. The Proposed Regulations provide guidance on several aspects of the PFIC rules and would require that a non-U.S. insurance company be actively managed by its own employees and officers to qualify as "active." The Proposed Regulations also provide that assets held to meet obligations under insurance contracts are treated as nonpassive, but they do not supply guidance on how to determine whether an asset is held to meet such obligations.

BACKGROUND

The PFIC rules are intended to prevent U.S. taxpayers from deferring tax by making investments through non-U.S. corporations. In general, a non-U.S. corporation is treated as a PFIC if at least 75 percent of its gross income is "passive income" (such as interest or dividends) or at least 50 percent 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 subject to an interest charge.

The PFIC rules recognize that insurance companies should not be treated as PFICs as a result of assets that they hold to back their reserves and provide that passive income does not include income that is derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and which would be taxed as an insurance company if it were a U.S. corporation. Prior to the publication of the Proposed Regulations, little guidance existed on the application of the insurance company exception, beyond a statement in the legislative history that income will not qualify for the insurance company exception to the extent that the insurance company

maintains financial reserves in excess of the reasonable needs of its insurance business. In recent years, a number of offshore reinsurance companies have entered into agreements with alternative investment managers to invest the assets backing their reinsurance contracts; the investors in these companies rely on the insurance company exception.

THE PROPOSED REGULATIONS

The Proposed Regulations confirm that an insurance business includes the issuance of insurance and annuity contracts and reinsurance of risk, as well as investment activities and administrative services that are required to support or that are substantially related to insurance contracts. The Proposed Regulations provide that the active conduct of an insurance business must include the performance of substantial managerial and operational services by the company's own employees and officers: the activities of independent contractors and employees of affiliates are not sufficient to satisfy this requirement.

The Proposed Regulations also clarify that income from investment assets held by an insurance company to meet its obligations under insurance and annuity contracts will not be treated as passive income for PFIC purposes. However, the IRS did not propose a specific method for determining the portion of an insurance company's assets that are held to meet obligations under insurance and annuity contracts, and solicits comments on appropriate approaches. As an example, the IRS suggested comparing the assets of an insurance company to a fixed percentage of its total insurance liabilities. Any such approach would presumably take proper account of the differences in the capital and reserve requirements applicable to life and property and casualty insurers or reinsurers. Moreover, any such approach should take into account regulatory requirements for both capital and reserves, reserving requirements imposed on ceding companies that look to offshore reinsurers to hold adequate assets to provide "credit for reinsurance" under applicable regulatory regimes, the capital requirements imposed by rating agencies in evaluating the creditworthiness and claims paying ability of a non-U.S. insurance company, and a non-U.S. insurance company's reasonable needs to hold capital to support future growth. The Proposed Regulations do not indicate whether or to what extent these factors will be taken into account in the final regulations.

The Proposed Regulations will be effective when issued in final form. Ultimately, the fact that the Proposed Regulations do not provide specific guidelines for determining what portion of an insurance company's assets will be treated as nonpassive assets means that insurers will continue to analyze these issues under all facts and circumstances applicable to their business, as they do today.

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Please do not hesitate to contact us with any questions.