

Senator Wyden Introduces New Bill Clarifying the Insurance Exception to the PFIC Rules

On June 25, 2015, Senate Finance Committee Ranking Member Ron Wyden introduced a bill (the "Bill") that would require insurance companies to maintain minimum levels of certain insurance liabilities in order to qualify for the exception to the passive foreign investment company rules applicable to insurance companies.

Background

The passive foreign investment company ("PFIC") rules generally require US shareholders in a PFIC to take into account their share of the PFIC's income currently in order to avoid generally unfavorable tax consequences when those US shareholders sell their PFIC stock or receive certain distributions from the PFIC. A foreign corporation is a PFIC if it owns passive assets or receives passive income above certain thresholds. However, in recognition of the key role that passive income plays in the operation of an insurance business, the PFIC rules contain an exception for passive income "derived in the active conduct of an insurance business" (the "Insurance Exception"). The exact contours of this rule are largely undefined, but legislative proposals, including a proposal last year from Representative David Camp and the current proposal from Senator Wyden, attempt to provide further clarity.

In addition to legislative proposals, the Treasury Department and Internal Revenue Service recently released administrative guidance in the form of proposed Treasury Regulations (the "Proposed Regulations") that would, if finalized in the form proposed, clarify when a company would be treated as engaged in the "active conduct" of an insurance business within the meaning of the Insurance Exception. Specifically, to qualify under the Proposed Regulations, a company's officers and employees must, based on all the facts and circumstances, carry out substantial managerial and operational activities without regard to activities undertaken on behalf of the foreign company by related parties or independent contractors.

The Bill

Under the terms of the Bill, in order to qualify for the Insurance Exception, in addition to being actively engaged in an insurance business, a foreign company must have "applicable insurance liabilities" that constitute more than 25% of its total assets. If the company fails this bright-line test, it may still temporarily qualify for the Insurance Exception, but only if the company's applicable insurance liabilities constitute more than 10% of the company's total assets, and, based on the facts and circumstances, (i) the company's failure to satisfy the 25% test is due solely to temporary circumstances involving the insurance business, and (ii) the company is predominantly engaged in the insurance business. A company with applicable insurance liabilities that constitute less than 10% of its total assets would not qualify for the Insurance Exception.

Applicable insurance liabilities are, with respect to a life or property and casualty insurance business, (i) loss and loss adjustment expenses and (ii) reserves for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity rates. The Bill does not include property and casualty reserves in applicable insurance liabilities, and it is not clear whether this was intended or is a drafting oversight. Applicable insurance

liabilities do not include deficiency, contingency or unearned premium reserves. The Bill is proposed to apply to tax years beginning after December 31, 2015.

Although not specifically addressed in the Bill, because the Bill retains the "active conduct" statutory requirement, it appears that the Proposed Regulations, if finalized, would apply in addition to the requirements of the Bill.

Comparison to Representative Camp's Proposal

The Bill reflects the latest iteration in a number of proposed requirements to meet the Insurance Exception. In February 2014, Representative David Camp released tax reform proposals that included a similar provision limiting the Insurance Exception. However, Representative Camp's proposal differed from the Bill in three important respects:

1. Representative Camp's proposal included a requirement that more than half the company's gross receipts for the taxable year consist of premiums. The Bill does not include such a requirement.
2. Representative Camp's proposal required that the applicable insurance liabilities of the corporation exceed 35% of the company's total assets and included unearned premium reserves within applicable insurance liabilities. While the Bill only requires that applicable insurance liabilities exceed 25% of the company's total asset (a lower threshold), unearned premium reserves are not taken into account as liabilities for purposes of this test.
3. Representative Camp's proposal provided a bright-line test for determining whether a company qualifies for the Insurance Exception. In contrast, under the Bill, if a company does not meet the 25% threshold, as long as the 10% threshold is met and the failure to satisfy the 25% threshold is due solely to temporary circumstances involving the company's insurance business, a facts and circumstances test applies to determine whether the company may qualify for the Insurance Exception.

Conclusion

The Bill takes a similar approach to Representative Camp's proposal by establishing an objective test that would apply in determining if a corporation satisfies the Insurance Exception. In addition, the Bill implicitly acknowledges that companies may not meet this objective test at all times during their life cycle, and therefore would permit companies who fail to meet the 25% threshold to continue to satisfy the Insurance Exception under a facts and circumstances analysis. The Bill would not establish a safe harbor for companies seeking to satisfy the Insurance Exception, because even insurance companies meeting the 25% threshold established by the Bill would be required to be engaged in the active conduct of an insurance business. As a result, it is possible that the requirements of the Bill would apply alongside the more fact-intensive requirements of the Proposed Regulations if the regulations are finalized in their current form. Nonetheless, the Bill follows the general approach of Representative Camp's proposal while incorporating some of the insurance industry's response to that proposal, and if enacted in a form similar to that proposed the Bill is likely to reduce the existing uncertainty in utilizing the Insurance Exception.

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