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TAXATION
A Section of the American Bar Association

Section of Taxation

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January 3, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Qualifying Insurance Corporation Exception from Passive Foreign Investment Company Status under Section 1297(f)

Dear Commissioner Rettig:

Enclosed please find comments on the qualifying insurance corporation exception from passive foreign investment company status under section 1297(f) of the Internal Revenue Code. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Eric Solomon

Eric Solomon
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
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AMERICAN BAR ASSOCIATION SECTION OF TAXATION COMMENTS ON THE NEW QUALIFYING INSURANCE CORPORATION EXCEPTION FROM PASSIVE FOREIGN INCOME COMPANY STATUS UNDER SECTION 1297(f)

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Stuart B. Katz. These Comments were reviewed by Jean Baxley, Kristen Hazel, Jason Kaplan, Arthur Lynch, Eric Miller, Surjya Mitra, Christopher Ocasal, John Owsley, and Clarissa Potter. They have been reviewed by Joan Arnold of the Committee on Government Submissions.

Although members of the Section of Taxation may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 3, 2019

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I. EXECUTIVE SUMMARY

Public Law 115-97,[1] formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," and known as the Tax Cuts and Jobs Act," (the "Act"), was enacted on December 22, 2017. The legislation includes sweeping individual, corporate and international tax changes.

These Comments address a specific change to the definition of a passive foreign investment company, as defined by section 1297(a) of the Internal Revenue Code of 1986, as amended,[2] with respect to insurance companies. The Internal Revenue Service (the "Service") and the Department of Treasury ("Treasury") have requested comments on the implementation of the amendments. In this Executive Summary we set forth our key recommendations for regulations to be promulgated with respect to section 1297(f).

In section II we set forth the background, and in section III we provide a detailed discussion of our recommendations.

We recommend that regulations:

- clarify that the term "loss and loss adjustment expenses" be interpreted to mean both paid and unpaid loss and loss adjustment expenses, so as to best reflect the intent of the statute to treat as a Passive Foreign Investment Company (PFIC) only those insurance companies that are holding assets that are excessive as compared to the assets used in the operation of the insurance business;

- clarify that the amount of losses taken into account in determining whether a corporation is a qualifying insurance corporation (a "QIC") is the undiscounted losses as reflected in the statutory statements prepared for the jurisdiction of residence;

- permit an insurance company to apply the 25 percent test based on the average of the ratio of reserves to assets each quarter, rather than based solely on the ratio as of the end of the year;

- make some allowance for companies whose reserves as a percentage of total assets may fluctuate substantially year-to-year (for example, regulations might permit a company to elect to apply the 25 percent test based on a three-year rolling average);

- provide that the "applicable financial statement" for a company be the financial statement that was prepared for "financial reporting purposes," i.e., that was prepared for the primary purpose of informing stakeholders;

[1] Pub. L. No. 115-97, 115th Cong., 1st Sess. (Dec. 22, 2017).

[2] Unless otherwise indicated, all section references are to the Code.

- provide guidance on the interaction of the section 1297(f) rule relating to QICs, the look-thru rule in section 1297(c) and the domestic look-thru rule in section 1298(b)(7); and

- allow a shareholder to make the election on its tax return to rely on the alternative facts and circumstances test as long as the shareholder has a reasonable basis to conclude that the company's applicable insurance liabilities are less than 10 percent of its total assets "due solely" to "runoff-related" or "rating-related" circumstances

II. BACKGROUND

As noted above, section 1297(a) provides that a PFIC means any foreign corporation if (i) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or (ii) the average percentage of assets held by such corporation during the taxable year which produce passive income or which are held for the production of such income is at least 50 percent.

Prior to the Act, section 1297(b)(2)(B) provided that "passive income" did not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation. Given the uncertain standard for separating investment assets used in an insurance business from "excess" investment assets, this rule in effect allowed all investment assets held by an insurance company that is predominantly engaged in an insurance business to be treated as non-passive assets.

The Act revised section 1297(b) to provide that income derived in the active conduct of an insurance business would be treated as not passive income only if earned by QIC. A QIC means, with respect to any taxable year, a foreign corporation:

> (A) which would be subject to tax under subchapter L if such corporation were a domestic corporation, and
>
> (B) the applicable insurance liabilities of which constitute more than 25 percent of its total assets, determined on the basis of such liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year.[3]

[3] I.R.C. § 1297(f)(1).

If a corporation fails to qualify as a QIC[4] solely because applicable insurance liabilities are 25 percent or less of total assets, a United States person that owns stock in such corporation may elect to treat such stock as stock of a QIC if:

(A) The applicable insurance liabilities of the corporation are at least 10 percent of the corporation's total assets, and

(B) Under regulations provided by the Secretary, based on the applicable facts and circumstances,

(i) The corporation is predominantly engaged in an insurance business, and

(ii) Such failure is due solely to runoff-related or rating-related circumstances involving such insurance business.[5]

"Applicable insurance liabilities" means, with respect to any life or property and casualty insurance business,

(i) Loss and loss adjustment expenses, and

(ii) 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 and morbidity risks.[6]

The amount of applicable insurance liabilities may not exceed the lesser of such amount:

(i) As reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or

(ii) As determined under regulations prescribed by the Secretary.[7]

"Applicable financial statement" means a statement for financial reporting purposes which:

(i) Is made on the basis of generally accepted accounting principles,

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[4] Due to a typographical error in the Act, section 1297(b)(2)(B) and section 1297(f)(1) refer to a "qualifying insurance corporation", while section 1297(f)(2) refers to a "qualified insurance corporation." For the sake of consistency, these Comments refer throughout to a "qualifying insurance corporation" or QIC.

[5] I.R.C. § 1297(f)(2). This test may be referred to herein as the "alternate facts and circumstances test."

[6] I.R.C. § 1297(f)(3)(A).

[7] I.R.C. §1297(f)(3)(B).

(ii) Is made on the basis of international financial reporting standards, but only if there is no statement which meets the requirements of clause (i), or

(iii) Except as otherwise provided by the Secretary in regulations, is the annual statement which is required to be filed with the applicable insurance regulatory body, but only if there is no statement which meets the requirements of clause (i) or (ii).[8]

The term "applicable insurance regulatory body" means, with respect to any insurance business, the entity established by law to license, authorize, or regulate such business and to which the applicable financial statement is provided.[9]

The look-thru rule of section 1297(c) provides that if a foreign corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, for purposes of determining whether such foreign corporation is a PFIC, such foreign corporation is treated as if it (1) held its proportionate share of the assets of such other corporation, and (2) received directly its proportionate share of the income of such other corporation.[10]

III. DISCUSSION

A. Enactment of section 1297 (formerly section 1296)

Section 1297[11] was added to the Code by the Tax Reform Act of 1986.[12] Then section 1296(b)(2)(B) was intended to provide relief from PFIC status for bona fide insurance companies (and also for banks in then-section 1296(b)(2)(A)).

As originally enacted, section 1296(b)(2)(B) provided that "passive income" did not include any income "derived in the active conduct of an insurance business by a corporation which would be subject to tax under subchapter L if it were a domestic corporation." This provision was subsequently amended by the Technical and Miscellaneous Revenue Act of 1988[13] to provide that passive income would not include income "derived in the active conduct

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[8] I.R.C. §1297(f)(4)(A).

[9] I.R.C. §1297(f)(4)(B).

[10] I.R.C. § 1297(c).

[11] Section 1297 was originally designated as section 1296. It was changed to section 1297 as part of the Taxpayer Relief Act of 1997, § 1122(a), P.L. 105-34, 105th Cong., 1st Sess. (Aug. 5, 1997).

[12] Pub. L. No. 99-514, 99th Cong., 2nd Sess. (Oct. 22, 1986). The purpose of the PFIC statute is to deny to U.S. persons the benefit of deferral of passive income earned by foreign corporations if U.S. persons are not otherwise subject to the subpart F rules of section 951.

[13] Pub. L. No. 100-647, 100th Cong., 2nd Sess. (Oct. 22, 1988).

of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation." This change was intended to limit the PFIC exception so that "income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business."[14]

However, as noted in the General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation, the statute gave regulatory authority to Treasury and the Service to restrict the exception for income derived by bona fide insurance companies "where it is necessary to prevent United States persons from earning what is essentially investment income in a deferred tax entity."[15] Entities engaged in the business of providing insurance may nevertheless be considered to derive passive income, and therefore be treated as PFICs, if "the entities maintained financial reserves in excess of the reasonable needs of their insurance business."[16] Income derived by insurance businesses that "operate as incorporated investment vehicles on behalf of shareholders or other related parties [should] be treated as passive income for purposes of these rules."[17]

An Appendix is attached which describes regulatory and other developments related to the insurance company exception from PFIC status since its enactment and prior to the Act.

B. Recommendations for Regulations under section 1297(f)

We have identified the following issues which we recommend be addressed by Treasury and the Service in regulations.

1. Definition of "applicable insurance liabilities"

As noted above, a foreign corporation will not be a QIC for a particular taxable year unless its "applicable insurance liabilities" constitute more than 25 percent of its total assets in that taxable year, determined on the basis of such liabilities and assets as reported on the corporation's "applicable financial statement."[18]

Applicable insurance liabilities are defined as (i) loss and loss adjustment expenses, and (ii) reserves (other than deficiency, contingency, or unearned premium reserves) for life and

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[14] H.R. Rep. No. 100-795, at 273 (1988).

[15] General Explanation of the Tax Reform Act of 1986 prepared by the staff of the Joint Committee on Taxation 1025 (the "Blue Book").

[16] *Id*.

[17] *Id*. at 1026. The Blue Book also singles out "captive insurance companies," which the Blue Book defines as corporations formed to acquire insurance coverage on behalf of related persons. The Blue Book states that a captive might not be treated as an insurance company for United States tax purposes because of the lack of risk-shifting, and therefore may be treated as a PFIC. *See Helvering v. LeGierse*, 312 U.S. 531 (1941).

[18] I.R.C. § 1297(f)(1)(B).

health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks.[19]

a. We recommend that regulations make clear that "loss and loss adjustment expenses" refers to reserves and losses.

Defining "insurance liabilities" in terms of "expenses" and "reserves" gives rise to uncertainty as to the meaning of "applicable insurance liabilities." The term "liability" has been used in the Code and regulations to describe both amounts not yet paid (e.g., reserves) as well as amounts actually paid.[20]

The term "unpaid loss and loss adjustment expenses" is a defined term for statutory accounting purposes. The National Association of Insurance Commissioners ("NAIC"), which provides guidance on statutory accounting principles, has stated that "unpaid loss and loss adjustment expense" is a balance sheet liability reflecting the reserves of property and casualty insurers for (i) reported losses, (ii) incurred but not reported losses and (iii) the expected payments for costs to be incurred in connection with the adjustment and recording of losses.[21]

The Conference Committee Report for the Act implies that the "loss and loss adjustment expenses" component of "applicable insurance liabilities" is intended to refer only to unpaid amounts (i.e., amounts in the nature of a reserve), as the report describes "applicable insurance liabilities" as "includ[ing]" "loss reserves for property and casualty, life, and health insurance contracts and annuity contracts."[22]

By describing applicable insurance liabilities in the property and casualty context as "loss and loss adjustment expenses," it is not clear whether Congress intended that only unpaid losses be treated as applicable insurance liabilities, or whether the omission of the word "unpaid" was intended to result in both paid and unpaid losses being included within the definition of applicable insurance liabilities.

Notwithstanding the language in the Conference Committee Report, there are compelling policy reasons why both paid and unpaid losses should be treated as applicable insurance liabilities. Failure to take both paid and unpaid losses into account risks presenting a misleading picture of a P&C company's applicable insurance liabilities as a percentage of assets. Companies

[19] I.R.C. § 1297(f)(3)(A).

[20] *See* former section 819(a)(2)(B) ("total insurance liabilities" means the sum of reserves (as defined in former section 801(c)), and amounts "necessary to satisfy the obligations under insurance or annuity contracts" (under former section 810(c)(3))); and Reg. § 1.446-1(c)(1)(ii)(B) (the term "liability" includes "any amount otherwise allowable as a deduction, cost, or expense for Federal income tax purposes").

[21] *See* NAIC, Statement of Statutory Accounting Principles No. 55 (Jan. 1, 2001). The courts and the Service have referenced NAIC accounting principles and NAIC-approved financial statements when interpreting provisions of the Code. *See*, *e.g.*, *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 866 (7th Cir. 1992); Chief Couns. Adv. 201642034 (2016).

[22] H.R. Conf. Report No. 115-466, at 670 (2017).

with short-tail business may have significant payouts and no significant unpaid liabilities in a given year. Such a company, if not treated as a QIC solely for that reason, would be treated as a PFIC even though it was clearly not the intent of the statute to cause such active insurance companies to be treated as PFICs.

If paid losses are taken into account for purposes of determining applicable insurance liabilities, logic requires that the assets used to pay off the liabilities should be added back to determine if the company's applicable insurance liabilities are more than 25 percent of total assets.

As an alternative to treating all paid and unpaid losses as applicable insurance liabilities, Treasury and the Service could provide to companies, such as those that write short-tail business, an election to include both paid and unpaid losses in their applicable insurance liabilities. In order to avoid manipulation by the taxpayer, the election could be made only once and would need to be applied consistently year-to-year.

We recommend that regulations issued by Treasury and the Service clarify that the term "loss and loss adjustment expenses" be interpreted to mean both paid and unpaid loss and loss adjustment expenses, so as to best reflect the intent of the statute to treat as PFICs only those insurance companies that are holding assets that are excessive as compared to the assets used in the operation of the insurance business.

b. We recommend that regulations make clear that unpaid losses are determined on an undiscounted basis.

For property and casualty insurance companies, gross income means the gross amount of investment income and underwriting income.[23] Underwriting income means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.[24]

Losses incurred is defined as losses paid (reduced by salvage and reinsurance recoverables), plus the increase during the taxable year in discounted unpaid losses.[25] Discounted unpaid losses are the unpaid losses shown in the annual statement filed by the taxpayer with the state insurance regulatory authority for the year ending with or within the taxable year of the taxpayer, discounted in the manner described in section 846(a)(2).[26]

New section 1297(f) is ambiguous as to whether losses are to be determined on a discounted basis (as they would be for purposes of determining underwriting income for tax purposes) or on an undiscounted basis (as they would be for statutory purposes).

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[23] I.R.C. § 832(b)(1)(A).

[24] I.R.C. § 832(b)(3).

[25] I.R.C. § 832(b)(5)(A).

[26] I.R.C. § 846(a)(2), (b)(1).

Given the overall purpose of the statute to identify insurance companies that have excess assets, we recommend that liabilities be determined on an undiscounted basis because that is generally closer to the amount of assets that local regulators or rating agencies would require the insurance company to retain.

The use of undiscounted unpaid losses is also consistent with the expression of the intent of Congress that the test for QICs should be determined based on the statutory statement rather than on tax-basis numbers. We recommend that Treasury and the Service issue regulations making clear that the amount of losses taken into account as applicable insurance liabilities be the undiscounted losses as reflected in the statutory statements. This would have the beneficial effect of (i) making it less likely that a truly active insurance company would inappropriately fail the QIC test, and (ii) basing the decision of whether an entity is a QIC on information that is more readily available to shareholders.

Accordingly, we recommend that the Service and Treasury promulgate regulations that require that applicable insurance liabilities be determined on an undiscounted basis.

c. We recommend that regulations permit the determination of the company's applicable insurance liabilities as a percentage of assets to be determined on a quarterly basis.

During the course of a year, an insurance company's applicable insurance liabilities as a percentage of total assets may fluctuate substantially due to losses and resulting reserve adjustments that take place in the course of the year. A company whose applicable insurance liabilities are greater than 25 percent of total assets for most of a taxable year may find that, due to unforeseen circumstances, its applicable insurance liabilities are less than 25 percent of total assets at the end of the year. Treating such a company as a PFIC based on a temporary failure to meet the 25 percent test would not be consistent with the intent of the statute to identify companies that hold an excessive amount of assets as compared to their reserves.

Accordingly, we recommend that Treasury and the Service promulgate regulations that permit an insurance company to apply the 25 percent applicable insurance liabilities test based on the average of the ratio of reserves to assets at the end of each quarter, rather than based solely on the ratio as of the end of the year.

d. We recommend that regulations make provision for insurance companies whose applicable insurance liabilities may fluctuate year to year.

Many insurance companies, including particularly companies that assume catastrophic risks, may, in a given year, have GAAP, IFRS or statutory reserves that are less than 25 percent of their total assets, while in years in which, for example, a catastrophic loss occurs, unpaid losses and loss adjustment expenses may substantially exceed 25 percent of total assets.

Although the nature of insuring catastrophic risks means that in some years losses and loss adjustment expenses may be less than 25 percent of total assets, these insurance companies that issue such coverages are no less insurance companies than life and non-life companies that do not assume catastrophic risks, and bear little resemblance to the type of insurance company hedge funds that have previously raised questions as to their status as active insurance companies. (See the Appendix for a discussion of hedge fund insurance companies.) Moreover, companies engaged in mortgage guarantee insurance and financial guaranty insurance, for example, also are subject to volatility of results because the underlying risk of default for each policyholder is not truly independent from that of other policyholders, which may result in substantial changes from year-to-year in reserves as a percentage of total assets - yet it is generally undisputed that such companies are active insurance companies.

Section 1298(b)(3) provides that a corporation will not be treated as a PFIC for any taxable year if the corporation was not a PFIC in any prior taxable year, and it is established to the satisfaction of the Secretary that substantially all of the passive income of the PFIC for the tax year is attributable to the disposition of one or more trades or business, i.e., the corporation is changing its business. We recommend that Treasury and the Service consider implementing a similar rule under their general authority to interpret section 1297(f), which is granted pursuant to section 1298(g) for the part that includes the PFIC rules.

Accordingly, we recommend that the regulations promulgated by Treasury and the Service make some allowance for companies whose reserves as a percentage of total assets may fluctuate substantially year-to-year. For example, regulations might permit a company to elect to apply the 25 percent test based on a three-year rolling average.

2. Identification of the "applicable financial statement"

a. Generally

The liabilities and assets which are the basis for concluding whether the foreign insurance company meets the definition of a QIC are determined based on the corporation's applicable financial statement. Section 1297(f)(4)(A) allows assets and liabilities to be determined, in descending order of preference, as reported in financials based on (i) GAAP, (ii) IFRS, and (iii) statutory accounting. In the case of statutory statements, section 1297(f)(4)(A)(iii) specifies that such statements may be chosen as the "applicable financial statement" if GAAP or IFRS statements are unavailable, "except as otherwise provided by the Secretary in regulations."

An "applicable financial statement" means "a statement for financial reporting purposes" which is made on one of the bases (GAAP, IFRS or statutory) described above, in descending order of preference.[27] Where a company prepares audited financials based on one, and only one, of these three bases, the choice of "applicable financial statement" is simple. However, for many companies, determining the "applicable financial statement" may prove difficult. In addition, as described further below, there is substantial ambiguity in section 1297(f) as to whether a

[27] It is also noted that although the statute in section 1297(f)(4)(A)(i) refers to financial statements made on the basis of generally accepted accounting principles, the legislative history to the Act makes clear that "generally accepted accounting principles" means United States GAAP. This means that a financial statement prepared on the basis of non-United States GAAP would not be considered an applicable financial statement for purposes of section 1297(f).

company may have more than one "applicable financial statement," and the uses to which that applicable financial statement may be put.

b. Identifying the "purpose" of a financial statement

In accordance with the general rule of statutory interpretation that Congress must be presumed to have intended the ordinary meaning of the words it used,[28] it should be presumed that by defining an "applicable financial statement" as "a statement for financial reporting purposes," Congress intended that (i) only a statement used "for financial reporting purposes" may qualify as an applicable financial statement, and (ii) it is possible for an insurance company to have more than one applicable financial statement (otherwise the statute would have defined the applicable financial statement as "the" statement for financial reporting purposes).[29]

The purpose of a financial statement is to inform potential and current stakeholders in a company of the financial condition of the company. Stakeholders could include customers, shareholders, lenders, regulators, rating agencies, trade organizations and potential business or merger/acquisition partners. In the case of a company that is publicly traded in the United States, financial statements are available to the public and to the Securities and Exchange Commission. Because the primary purpose of financial statements is to inform stakeholders, and not, for example, to influence the United States federal income tax liability of a company or its shareholders, such financial statements are thought to have greater integrity because they are not likely to have been manipulated to achieve a specific tax result.

As a general matter the type of financial statements prepared by companies, and whether such financial statements are audited, depends on the identity of their stakeholders. Furthermore, different stakeholders may require different financials. For example, a company borrowing from a United States lender will likely be required to produce audited GAAP financials, while a company borrowing from a non-United States lender may be required to produce IFRS financials. A regulated insurance company will be required to produce statutory financial statements for its regulator as well as for its rating agency. A company publicly traded in the United States will be required to produce audited GAAP financials.

The key phrase in section 1297(f)(4)(A) is "for financial reporting purposes." We propose, in line with the discussion above, that a financial statement be considered prepared "for financial reporting purposes" if the purpose of the financial statement is to inform a significant stakeholder of the company, for whose benefit the statement is prepared, regarding the financial condition of the company. This would require the regulations to build in some flexibility in determining the applicable financial statement for a particular entity since a company that

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[28] *E.g.*, *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980).

[29] The latter proposition is further supported by the language of section 1297(f)(3)(B), which on its face caps the applicable insurance liabilities as reported on an applicable financial statement at an amount equal to the applicable insurance liabilities as reported on a second applicable financial statement (the annual statement filed with the applicable insurance regulatory body). See further discussion below.

prepares financial statements on more than one basis may have multiple stakeholders, each of which has an interest in a different financial statement.

c. Choosing among multiple financial statements

(1) Preference given to financial statements that inform stakeholders

Companies within a corporate group may frequently have a number of different, overlapping financial statements, and such financial statements may not always be prepared on the same basis. For example, a United States publicly-traded group will have prepared consolidated GAAP financials, while individual companies within the group (for example, non-United States companies) may also be required to produce IFRS financials or, in the case of insurance companies, statutory financials.

Given the multiplicity of financial statements which may be prepared for a non-United States insurance company, we recommend that regulations provide that it is presumed that the "applicable financial statement" for a company is the financial statement that was prepared for the primary purpose of informing stakeholders regarding the financial condition of the company.

We recommend, however, that this presumption be rebuttable by a non-United States insurance company if it can establish that GAAP or IFRS financial statements prepared on a stand-alone basis were not prepared for the primary purpose of informing an important stakeholder or stakeholders regarding the financial status of the company. In such case, the statutory statement for the non-United States insurance company would be the applicable financial statement. Since it may be presumed that a company would not prepare a GAAP or IFRS financial statement unless there were a reason to do so, the circumstance in which a company will have prepared a GAAP or IFRS financial statement for which there is no significant stakeholder should be comparatively rare.

(2) Choosing the shareholder as the most important stakeholder

Where a company has prepared more than one financial statement, each of which is directed at a different stakeholder, Treasury and the Service may choose to give preference to the financial statement that is the company's primary means of providing information to shareholders, since in the case of a company owned in whole or in part by United States shareholders, it is the shareholders who have the greatest stake in whether the company is a PFIC or not. In some cases, however, as where the company being tested for PFIC status is not directly owned by United States shareholders, there may not be a stand-alone financial statement prepared for shareholders, in which case another financial statement would need to be identified as the applicable financial statement.

d. Selecting the applicable financial statement where there is no stand-alone GAAP or IFRS statement

Where a non-United States insurance company is part of a GAAP or IFRS consolidated financial statement, but does not prepare a stand-alone GAAP or IFRS financial statement, we recommend that the statutory statement be the applicable financial statement, and not the consolidated GAAP or IFRS financial statement, because, while the GAAP or IFRS financial statement is prepared for a stakeholder of the parent company, it is not prepared for the insurance company or a direct stakeholder of the insurance company.

e. We recommend that Treasury and the IRS clarify whether there can be more than one applicable financial statement

As noted above, the statute as written arguably admits of there being more than one applicable financial statement.

Section 1297(f)(3)(B) states that the "applicable insurance liabilities" referred to in section 1297(f)(3)(A) may not exceed (subject to regulations) the amount as reported to the applicable insurance regulatory body in the applicable financial statement described in section 1297(f)(4)(A) (or, if less, the amount required by applicable law or regulation). This rule is susceptible to multiple interpretations. One interpretation is that applicable insurance liabilities as reported on an applicable financial statement based on GAAP or IFRS are limited to the applicable insurance liabilities reported on a (different) applicable financial statement which is a statutory statement.

An alternative interpretation is that the cap on applicable insurance liabilities imposed by section 1297(f)(3)(B) is not necessarily determined by reference to the statutory statement, but may be determined by reference to any other applicable financial statement. For example, if applicable insurance liabilities are determined under an IFRS applicable financial statement, the amount of such applicable insurance liabilities may be capped based on a GAAP financial statement as long as the GAAP financial statement is "reported to" the applicable insurance regulatory body.[30] This interpretation also does not admit of only one applicable financial statement, since it would be illogical for applicable insurance liabilities as reported on an applicable financial statement to be capped by itself.

In applying the rule relating to the limitation on the amount of liabilities which may be treated as applicable insurance liabilities, it may be that a GAAP or IFRS statement may be treated as the applicable financial statement for purposes of determining the amount of the applicable insurance liabilities, but the statutory financial statement would be treated as the applicable financial statement for purposes of determining the cap on applicable insurance liabilities.

f. Audited vs. unaudited financial statements

In determining which financial statement is the "applicable financial statement," it should not matter whether the financial statement is audited or unaudited. If the company is not required to prepare audited financials, unaudited financials may be treated as the applicable financial statement as long as the financial statement is the primary means by which the company informs stakeholders of its financial condition. However, in most cases, a company's financial statements

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[30] The ambiguity of this provision is exacerbated by the fact that section 1297(f)(3)(B) refers to an applicable financial statement "reported to" the applicable insurance regulatory body, whereas section 1297(f)(4)(A) refers to the statutory statement "which is required to be filed with" the applicable insurance regulatory body.

will be audited, because of the interest of stakeholders in confirming the integrity of the financial statement.

g. Stand-alone vs. consolidated financial statements

Where a group of companies prepares financial statements on both a consolidated basis and a stand-alone basis, we recommend that a company be permitted to elect to treat either as the applicable financial statement, provided that the taxpayer can establish that the applicable financial statement was prepared "for financial reporting purposes" (i.e., for the benefit of one or more significant stakeholders). Where the group of companies prepares financial statements on a consolidated basis and the foreign insurance company does not have a stand-alone financial statement, we recommend that the taxpayer be permitted to use any reasonable method to back out of the consolidated statement financial results for the entity being tested for QIC status.

h. Use of pro forma financial statements

Permitting the taxpayer the use of any reasonable method to determine the financial results for an entity being tested for QIC status may require permitting the taxpayer to use pro forma financial statements. The stakeholder(s) for a pro forma financial statement will be the direct or indirect shareholders, but their sole interest in the pro forma financial statement will be that the financial statement will permit the shareholder to reach a conclusion as to whether the company is a PFIC.

i. Duty of consistency

The flexibility proposed above to be provided to taxpayers in determining the applicable financial statement may be tempered by requiring that the taxpayer consistently use the same statement as the applicable financial statement from year to year. A consistency requirement would support the integrity of the financial statement as a basis for determining QIC status, would prevent whipsawing of the Service, and would provide increased certainty to shareholders year-to-year as to whether the company is a PFIC.

j. Recommendations

Based on the foregoing, we make the following recommendations:

1. Regulations should make clear what it means for a financial statement to be prepared "for financial reporting purposes."

2. The "applicable financial statement" for a company is the financial statement that was prepared for the primary purpose of informing stakeholders regarding the financial condition of the company.

3. Where a non-United States insurance company prepares stand-alone financials based on GAAP or IFRS, such GAAP or IFRS statements should be preferred as the applicable financial statement under section 1297(f)(4)(A), even if the non-United States insurance company also

prepares statutory financial statements for specific stakeholders such as regulators and rating agencies.

4. However, the non-United States insurance company may treat the statutory statement as the applicable financial statement if the non-United States insurance company can establish that GAAP or IFRS financial statements prepared on a stand-alone basis were not prepared for the primary purpose of informing an important stakeholder or stakeholders regarding the financial status of the company.

5. Where a non-United States insurance company is part of a GAAP or IFRS consolidated financial statement, but does not prepare a stand-alone GAAP or IFRS financial statement, the statutory statement should be the applicable financial statement.

6. Where a group of companies prepares financial statements on both a consolidated basis and a stand-alone basis, we recommend that a company be permitted to elect to treat either as the applicable financial statement, provided that the taxpayer can establish that the applicable financial statement was prepared “for financial reporting purposes” (*i.e.*, for the benefit of one or more significant stakeholders). Where the group of companies prepares financial statements on a consolidated basis and the foreign insurance company does not have a stand-alone financial statement, we recommend that the taxpayer may be permitted to use any reasonable method to back out of the consolidated statement financial results for the entity being tested for QIC status.

3. Clarification of the section 1297(c) look-thru rule for insurance groups and interaction with the section 1297(f) QIC rules

a. Generally

Under section1297(c), if a foreign corporation owns (directly or indirectly) at least 25 percent of the stock (by value) of another corporation, for purposes of determining whether such foreign corporation is a passive foreign investment company, such foreign corporation shall be treated as if it held its proportionate share of the assets of such other corporation, and received directly its proportionate share of the income of such other corporation. This look-thru rule applies without regard to whether the subsidiary corporation is a domestic corporation or a foreign corporation.

Generally, the assets and income of subsidiaries of a foreign parent are identified as active or passive, based on the activities of the respective subsidiaries, and aggregated as they tier up to the parent level to determine if the foreign parent is a PFIC.

There is some ambiguity, however, as to how the PFIC insurance exception and look-thru rule (pre-tax reform) interact and are applied to 25% subsidiaries of a foreign insurance company parent. Under one approach considered by taxpayers, the look-thru rule operates so that the status of the income and assets of a 25% subsidiary of a foreign insurance company parent is determined at the level of the subsidiary, and tiers up through the chain of ownership to the parent company without affecting the status of the income or assets as passive or non-passive in any intermediary company or the top-tier foreign corporation.[31] Under an alternative approach, to the extent a 25% subsidiary of an insurance company holds passive assets, a proportionate share of those assets would tier up to the insurance company parent as passive assets but, pursuant to section 1297(b)(2)(B), could be treated as active assets in the hands of the insurance company parent provided dividends on the shares of the 25% subsidiary and any gain recognized on a sale or exchange of those shares would be considered income "derived in the active conduct of an insurance business" in the hands of the insurance company parent.

These Comments assume that the former approach is correct and that the look-thru rule operates so that the status of the income and assets of a subsidiary insurance company of a foreign insurance company parent is determined at the level of the subsidiary, and tiers up through the chain of ownership to the parent company without affecting the status of income or assets as passive or non-passive of any intermediary company or the top-tier foreign corporation.[32]

This look-thru rule would presumably apply for purposes of determining whether a foreign insurance company is a QIC, therefore assets and income of subsidiaries of that

[31] *See* Ocasal, 931 T.M., U.S. Income Taxation of International Insurance Activities, III.A.3.a.(5)(d).

[32] *See id.*

corporation would be tested under section 1297(b) to determine whether the subsidiaries have passive income and assets generating passive income.

What is not obvious is whether a direct or indirect insurance subsidiary (the "Insurance Subsidiary") of the foreign insurance company being tested for QIC status (the "Tested Company") must itself be a QIC in order for its income and assets to be treated as non-passive, and if so, how the test for QIC status should be applied to the Insurance Subsidiary.

If the Insurance Subsidiary must be tested for QIC status, under certain circumstances we recommend that the test ought to be applied on an aggregated insurance group basis, although the explicit authority for this treatment is not obvious. In particular, where the Tested Company and the Insurance Subsidiary are included within a single consolidated financial statement (which is an applicable financial statement under section 1297(f)(4)) the application of the 25 percent test arguably is appropriate and should not be difficult to apply. If the Tested Company and the Insurance Subsidiary are located in the same country, and applicable financial statements are available for both companies which are made on the same accounting basis (i.e., GAAP, IFRS or statutory accounting) then the assets and liabilities of the companies can simply be aggregated.

If, however, the Tested Company and the Insurance Subsidiary have stand-alone financial statements that are applicable financial statements with respect to their respective companies, but are not made on the same accounting basis, the assets and liabilities cannot be simply aggregated, and we recommend that each company be evaluated separately to determine whether its applicable insurance liabilities constitute more than 25 percent of its total assets.

b. Domestic Insurance Subsidiaries

One obstacle to testing an Insurance Subsidiary for QIC status is that the definition of QIC includes only a "foreign corporation." Consequently, it is not clear how the test for QIC status should be applied, if at all, to a domestic Insurance Subsidiary of a foreign Tested Company.

If the purpose of the PFIC rules generally is to prevent inappropriate deferral of taxable income by United States shareholders of a foreign corporation, then it is our view that it would be highly inappropriate to treat income and assets of a domestic insurance subsidiary, which is subject to United States taxation, as being passive in nature. For this reason, from a policy perspective, we recommend that the income and assets of a domestic insurance subsidiary generally be treated as per se active. However, because the language of section 1297(f)(1) does not admit of treating a domestic subsidiary as a QIC, reliance on the broad grant of regulatory authority in section 1298(g) would need to be availed of to fill in the gap.[33]

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[33] The IRS has on one previous occasion asserted the authority under section 1298(g) to promulgate taxpayer-favorable regulations under the PFIC rules to address an issue not specifically addressed in the statute. Notice 2014-28, 2014-18 I.R.B. 990. In that notice, the IRS stated that the proposed regulatory change would be consistent with the tax policies underlying the PFIC rules.

There are two alternatives for applying the look-thru rule when determining whether the Tested Company is a PFIC where the Tested Company has one or more Insurance Subsidiaries.

The first alternative is to apply the test in section 1297(f)(1) at the level of the Tested Company, taking into account the assets and income of the Insurance Subsidiaries. In this approach, assets and income of the Insurance Subsidiaries would be tested at the Tested Company level regardless of whether the Insurance Subsidiaries are domestic or foreign. This alternative therefore avoids one potential difficulty with the language of section 1297(f)(1), which is that it limits the definition of QIC to foreign corporations.

There are however certain challenges to this approach which must be resolved, ideally through regulations:

- Testing Insurance Subsidiaries for QIC status at the Tested Company level would require tiering up not just the assets and income of the Insurance Subsidiaries, but also their liabilities (reserves) and activities. However, the look-thru rule of section 1297(c) provides only that assets and income of subsidiaries tier up, and does not provide that liabilities or activities of a subsidiary tier up. If the insurance activities of the Insurance Subsidiary may not tier up to the Tested Company, the Tested Company likely would not be treated as an insurance company under Subchapter L.

- Even if the activities did tier up to the Tested Company, many multinational groups with United States investors have both insurance and non-insurance operations. A Tested Company that is primarily a holding company with both insurance and non-insurance subsidiaries may fail to qualify as a QIC under this approach, despite the fact that the Insurance Subsidiary would otherwise meet the requirements of section 1297(f) on a standalone basis.

- This approach would be inconsistent with the proposed PFIC Banking Exception regulations, which prevent aggregating the results of look-thru subsidiaries for purposes of the "qualified bank affiliate" test (see Proposed Regulation section 1.1296-4(i)(2)[34]).

- This approach may allow groups with look-thru subsidiaries that have scant insurance activities to benefit from the PFIC insurance exception by "pooling" the assets and income of other look-thru subsidiaries with scant insurance activities, despite the fact that no subsidiary would qualify as a QIC on a standalone basis.

- How would one determine the "applicable financial statement" based on this approach? What if the group does not have a consolidated financial statement that matches the entities which are treated as look-thru subsidiaries? For example, for financial reporting purposes a group may be required to consolidate special

[34] Prop. Reg. § 1.1296-4(i)(2), 60 Fed. Reg. 20,922 (1995).

purpose entities that for tax purposes are not treated as owned by the Tested Company.

The second alternative is to apply the test for QIC status at the level of the subsidiary, with the result that, if the subsidiary is itself a QIC, its assets and income tier up to the Tested Company as nonpassive. This approach enables a balanced application of the QIC determination to large insurance groups and groups with both insurance and non-insurance operations by preventing the distortive results that can occur if done on an aggregate basis. The applicable financial statement in this case presumably would be each subsidiary's standalone GAAP, IFRS or statutory statement, a document that very likely exists in all circumstances.

There are potential challenges to this approach as well:

- The statute could be read as only referring to the Tested Company when defining a QIC, thereby prohibiting the evaluation of QIC status to be made at the Insurance Subsidiary level.

- In the case of insurance groups that have "stacked" insurance companies (i.e., in a vertical chain), testing each entity for QIC status separately may produce different results than if aggregation were allowed. If the stacked subsidiaries operated in the same country, and the local insurance regulator views them as a consolidated whole, this may produce an inappropriate result.

  One way of resolving this issue may be to adopt a "same-country exception" or "same-country election" (to be made by Tested Company) to aggregate the results of stacked insurance subsidiaries for purposes of testing QIC status. This exception or election would be appropriate where, as is likely, a single consolidated financial statement exists for the stacked companies. Alternatively, a "qualified affiliate" test could be developed, similar to the PFIC Banking Exception.

The single most troublesome challenge to applying the QIC test at the Insurance Subsidiary level, however, is that the definition of QIC seemingly precludes treating a domestic Insurance Subsidiary as a QIC. This seeming oversight in the statute may, however, point towards a solution in which the activities of a domestic company, which are already taxed in the United States, do not have a detrimental effect on the ability of the Tested Company to qualify for the exception from PFIC status.

Given the ambiguity in the statute regarding how the look-thru rule applies in this context, the problem of the domestic Insurance Subsidiary may admit of more than one potential solution.

Alternative 1: The assets and income of a domestic Insurance Subsidiary are treated as *per se* nonpassive if the Insurance Subsidiary is subject to tax under Subchapter L.

Benefits of this approach:

- Income of a domestic insurance company is subject to tax in the United States, therefore from a policy standpoint there is no reason why it should be treated as passive (which would make it more likely that Tested Company would be a PFIC).

- Consistent with the PFIC Banking Exception, thereby putting insurance companies on an equal footing with banks.

- Administratively easy to implement.

Detriments of this approach:

- Section 1297(b)(2)(B) and section 1297(f) appear to not grant the regulatory authority to make such a rule (contrast this with the language in section 1297(b)(2)(A) for the PFIC banking exception). While section 1298(g) contains a broad grant of authority, it is unclear whether such a "*per se* nonpassive" rule could be written under section 1298(g) since section 1298(g) gives Treasury the authority to make interpretive regulations (i.e., regulations that interpret the statute) as opposed to legislative regulations (which may go beyond interpreting the language of the statute in order to effect the purpose of the statute).

Alternative 2: The PFIC insurance exception does not apply at all to the assets and income of a domestic Insurance Subsidiary (*i.e.*, the Insurance Subsidiary is treated as *per se* passive).

Benefit of this approach: appears consistent with a literal reading of section 1297(f).

Detriments of this approach:

- There is no statement of Congress, whether in legislative history to the Act, legislative history to the PFIC rules or the PFIC insurance exception, or in regulatory and other developments related to the insurance company exception from PFIC status since its enactment and prior to the Act (see Appendix) which supports the taxpayer-unfavorable rule that income and assets of a company that is fully subject to taxation in the United States be treated as *per se* passive when assessing the PFIC status of a foreign Tested Company that owns the domestic company.

- Income of a domestic insurance company is subject to tax in the United States, therefore from a policy standpoint there is no reason why it would be treated as *per se* passive (making a Tested Company more likely to be a PFIC).

- This rule would be inconsistent with the PFIC banking exception (section 1297(b)(2)(A)) and Proposed Regulation section 1.1296-4,[35] which makes income and assets of a domestic bank nonpassive. We do not see a policy reason to treat banks differently than insurance companies in this context.

- This rule would be inconsistent with that of any other industry, which does not have such a "per se passive" result. We do not see a policy reason to treat insurance companies differently.

- This rule would make it less attractive for non-United States insurance groups to invest in the United States through subsidiaries (due to the increased risk of PFIC status and resulting negative impacts to their investor base). This could negatively impact United States job creation, availability of capital to domestic insurance groups, and insurance premium pricing for United States policyholders, and is contrary to the overall purpose of the Act.

<u>Alternative 3</u>: Issue no regulations under section 1297(c) or section 1297(f), but rely on the section 1298(b)(7) domestic look-through rule.

Benefit of this approach: requires no action.

Detriments of this approach:

- The section 1298(b)(7) look-through rule is of very limited applicability. In order for section 1298(b)(7) to apply, the Tested Company must own at least 25% of the domestic subsidiary corporation directly (in addition to other requirements). As a practical matter, this makes the exception of limited use for many insurance groups. Due to regulatory and other business reasons, it is often impossible to restructure the group so as to meet the requirements for this exception.

- One could argue that the general look-thru rule of section 1297(c) could be applied prior to and in conjunction with the domestic look-through rule of section 1298(b)(7), thereby causing stock of a lower-tier domestic corporation to be treated as directly held by the Tested Company. However, legislative history to section 1297(c)[36] and certain IRS private rulings[37] take the view that stock in a look-

[35] Prop. Reg. § 1.1296-4 (1995).

[36] H.R. Rep No. 100-795 (1988), at 268; S. Rep No. 100-445 (1988), at 282.

[37] *E.g.*, Private Letter Ruling 201515006 (Nov. 21, 2014); Private Letter Ruling 200813036 (Dec. 19, 2007).

thru subsidiary is disregarded for purposes of section 1297. Therefore, it is unclear how one could meet the 25% ownership requirement under section 1298(b)(7) on the basis of applying the general look-thru rule, absent additional guidance.

Alternative 4: Issue regulations to clarify that, since the Tested Company is treated as holding the assets and receiving the income of a domestic Insurance Subsidiary, such assets and income remain eligible for the PFIC Insurance Exception.

Benefit of this approach: consistent with literal reading of section 1297(f).

Detriment of this approach: Requires testing for QIC status at the level of the Tested Company. See above for issues associated with aggregate testing for QIC status.

Alternative 5: Issue regulations to clarify that, in the case of look-thru Insurance Subsidiaries, the requirements of section 1297(f)(1) and (2) are applied at the level of the look-through subsidiary (whether domestic or foreign). The reference to a "foreign" corporation in section 1297(f)(1) may be read to refer to the Tested Company. Regulations are expanding upon this definition in the case of Look-Through Subsidiaries.

Benefit of this approach: would require testing for QIC status at the Insurance Subsidiary level – see above for benefits associated with that approach.

Detriment of this approach: appears to be a strained reading of section 1297(f)(1).

Based on the competing benefits and detriments of the alternatives, we recommend that Treasury and the Service promulgate regulations that provide useful guidance on the interaction of the section 1297(f) rule relating to QICS, the look-thru rule in section 1297(c) and the domestic look-thru rule in section 1298(b)(7).

4. Application of the alternative facts and circumstances test

Section 1297(f)(2) provides that if a corporation fails to qualify as a QIC solely because the percentage determined under section 1297(f)(1)(B) is 25 percent or less, a United States person that owns stock in such corporation may elect to treat such stock as stock of a QIC if (A) the percentage so determined for the corporation is at least 10 percent, and (B) under regulations provided by the secretary, based on the applicable facts and circumstances, (i) the corporation is predominantly engaged in an insurance business, and (ii) such failure is due solely to run-off related or rating-related circumstances involving such insurance business.

The insurance industry has noted that many insurers, especially writers of natural catastrophe reinsurance, are at risk of failing the 25 percent test, even though such insurers and reinsurers are "bona fide" insurance companies that expected relief from PFIC status under then-section 1296(b)(2)(B) as enacted by the Tax Reform Act of 1986, and even though these reinsurers likely do not present the kinds of abusive fact patterns that are targeted by the new QIC provision.

Consequently, it is likely that the shareholders of many bona fide insurance companies will be forced to rely on the alternative facts and circumstances test of section 1297(f)(2). In this regard it is important to note that the status of a company as a PFIC is a concern more of the shareholder than of the company itself. Thus, the alternative facts and circumstances test of section 1297(f)(2) is not an alternative to be exercised by the company, but an election to be exercised by the shareholder.

We recommend that any regulations issued by Treasury and the Service recognize that a United States shareholder of a foreign corporation will often have difficulty obtaining information about the corporation sufficient to allow the shareholder to reach a conclusion as to whether the foreign corporation is a PFIC. Even if a United States shareholder is able to determine the company's applicable insurance liabilities as a percentage of its total assets, in many cases it may be difficult for the shareholder to have access to information sufficient to allow the shareholder to conclude that applicable insurance liabilities that are at least 10 percent but not more than 25 percent of the total assets of the corporation are "due solely" to "runoff-related" or "rating-related" circumstances.

The terms "runoff-related" or "rating-related" are not terms previously used anywhere in the Code, or even used in a tax-related case. We recommend that Treasury and the Service therefore provide clear guidance as to what those terms mean in the context of the QIC test.

In particular, we recommend that the term rating–related be broadly defined to include not only a circumstance in which a rating agency explicitly requires a specific level of capital to attain a particular credit rating. The following circumstances (not an exclusive listing) may also be considered as "rating-related" circumstances where a higher level of capital is required as compared to reserves:

- To demonstrate superiority over competitors;
- To enter a new line of business or new geographic area;
- To counteract negative public perception of a company that has previously suffered from adverse publicity, whether or not as a result of financial weakness; or
- To meet standards set by a regulator, whether it be a regulator with jurisdiction over the entity itself or over a related party.

Accordingly, we recommend that Treasury and the Service issue regulations that allow a shareholder to make the election to rely on the alternative facts and circumstances test as long as the shareholder has a reasonable basis to conclude that the company's applicable insurance liabilities are less than 25 percent (but at least 10 percent) of its total assets "due solely" to "runoff-related" or "rating-related" circumstances.

We propose the following standards for determining whether a shareholder has a reasonable basis for concluding that the insurance company satisfies the alternative facts and circumstances test:

a) The level of reserves as a percentage of assets for a foreign corporation that is in run-off is comparable to that of domestic corporations in the same line of business, on the grounds that domestic corporations would generally not be tax-motivated to hold assets that significantly exceed the amount necessary to support reserves. Whether a domestic corporation is "similarly situated" as compared to a foreign insurance company may be determined by applying principles similar to those used to assess comparability under Regulation section 1.482-1(d).

b) The level of reserves as a percentage of assets for a foreign corporation is comparable to that of domestic corporations in the same line of business with a similar credit rating, on the grounds that domestic corporations would normally not be tax-motivated to hold assets that significantly exceed the amount necessary to support reserves. As above, whether a domestic corporation is "similarly situated" as compared to a foreign insurance company may be determined by applying principles similar to those used to assess comparability under Regulation section 1.482-1(d).

c) A rating agency has provided a letter of certification, whether to the foreign insurance company or the United States shareholder of a foreign insurance company, indicating that the level of assets as compared to reserves is necessary to maintain the company's credit rating.

d) The amount of assets as compared to reserves held by a foreign insurance company are required by the local regulator. Whether assets and reserves may be determined as required by the local regulator may be determined using standards similar to section 954(i).

We recommend that Treasury and the Service consider other bases on which a shareholder in a potential PFIC would be able to conclude that the foreign insurance company is a QIC, even though the ratio of liabilities to assets is less than 25 percent, based on runoff-related or rating-related factors. In particular, we recommend that "rating-related factors" not be limited to situations where a taxpayer's rating would be downgraded if its level of capital were reduced, but may also include situations in which the taxpayer wishes to improve its credit rating (or improve ratios, such as its solvency ratio, that might have a beneficial impact on rating).

IV. APPENDIX

High-level Summary of Precursors to Section 1297(f) as Enacted in 2017

A. Notice 2003-34

Beginning in mid-2003, it came to the attention of Treasury and the Service that some foreign companies were being established with the intent to avoid PFIC status and to defer United States tax on investment income by treating the companies as insurance companies.[38] As stated in Notice 2003-34:

> Treasury and the Internal Revenue Service have become aware of arrangements, described below, that are being used by taxpayers to defer recognition of ordinary income or to characterize ordinary income as a capital gain. The arrangements involve an investment in a purported insurance company that is organized offshore which invests in hedge funds or investments in which hedge funds typically invest. This notice alerts taxpayers and their representatives that these arrangements often do not generate the claimed federal tax benefits.

Notice 2003-34 provided a description of what Treasury and the Service considered to be a "typical" abusive arrangement. A typical arrangement involved a United States taxpayer, defined as the "Stakeholder," who invested (directly or indirectly) in the equity of an enterprise, usually a foreign entity (defined as "FC"), which is "organized as" an insurance company. The Notice assumed that the FC complies with all applicable local laws regulating insurance companies.

FC issues contracts which are designated as "insurance" or "annuity" contracts to reinsure risks underwritten by insurance companies (presumably either related or unrelated companies). The Notice stipulates that some of the contracts do not cover "insurance risks", while other contracts significantly limit the risks assumed by FC through the use of "retrospective rating arrangements, unrealistically low policy limits, finite risk transactions, or other similar devices."

The Notice further stipulates that FC's "actual insurance activities," if any, are relatively small compared to its investment activities. FC invests its capital, including capital received in the form of "premium" payments, either in hedge funds or in "investments in which hedge funds typically invest." As a result, FC's portfolio generates investment returns that substantially exceed the needs of FC's insurance business. It is assumed that FC does not currently distribute earnings to its Stakeholder.

Stakeholder takes the position that FC is an insurance company engaged in the active conduct of an insurance business and is not a PFIC. Therefore, Stakeholder will not be

[38] Notice 2003-34, 2003-23 I.R.B. 990 (May 9, 2003); *see also* Background and Data with Respect to Hedge Fund Reinsurance Arrangements, Joint Committee on Taxation (July 31, 2014).

subject to the disadvantageous PFIC regime and when Stakeholder disposes of its interest in FC, it will recognize capital gain instead of ordinary income.

In its response to the above perceived abuse, the Service stated in the Notice that the Service will scrutinize these arrangements and will apply the PFIC rules where it determines that FC is not an insurance company for federal tax purposes.

B. Baucus Proposal

In November 2013, Senate Finance Committee Chairman Max Baucus (D-Mont) released an international tax reform staff discussion draft (the "Baucus Proposal"). The Baucus Proposal stated that the term passive income for purposes of the PFIC rule means, with respect to any foreign corporation, any income which would be foreign personal holding company income as defined in section 954 if the foreign corporation were a controlled foreign corporation.

Under the Baucus Proposal, foreign personal holding company income would not include qualified insurance income of a qualifying insurance company. The term "qualified insurance income" means income of a qualifying insurance company which is:

(A) Received from a person other than a related person and derived from the investments made by a qualifying insurance company or a qualifying insurance company branch of its reserves allocable to exempt contracts or of 80 percent of its unearned premiums from exempt contracts, or

(B) Received from a person other than a related person and derived from investments made by a qualifying insurance company or a qualifying insurance company branch of an amount of its assets allocable to exempt contracts equal to:

(i) In the case of property, casualty, or health insurance contracts, one-third of its premiums earned on such insurance contracts during the taxable year, and

(ii) In the case of life insurance or annuity contracts, 10 percent of the reserves described in subparagraph (A) for such contracts.

C. Camp Proposal

In February of 2014, House Ways and Means Committee Chairman Dave Camp (R-MI) released draft legislation which was called the "Tax Reform Act of 2014" (the "Camp Proposal").

Among the proposed changes to the Code in the Camp Proposal was a provision to amend the insurance company exception from PFIC status. Under the Camp Proposal, section 1297(b)(2)(B) would have been revised to provide that income derived in the active conduct of an insurance business by a corporation would not be treated as passive income if (i) such corporation would be subject to tax under subchapter L if such corporation were a domestic corporation, (ii) more than 50 percent of the corporation's gross receipts for the taxable year consisted of premiums, and (iii) the applicable insurance liabilities of such corporation constituted more than 35 percent of its total assets as reported on the corporation's applicable financial statement for the year with which or in which the taxable year ends.[39] "Applicable insurance liabilities" was defined as, with respect to any life or property and casualty insurance business, (i) loss and loss adjustment expenses, (ii) unearned premiums, and (iii) reserves (other than deficiency or contingency reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks (not to exceed the amount of such reserve that is required to be reported to the home country insurance regulatory body).

Under the Camp Proposal, the term "applicable financial statement" means a statement for financial reporting purposes which (i) is made on the basis of generally accepted accounting principles, (ii) is made on the basis of international financial reporting standards, but only if there is no statement that meets the requirement of clause (i), or (iii) except as otherwise provided by Treasury in regulations, is the annual statement which is required to be filed with the home country insurance regulatory body, but only if there is no statement which meets the requirements of clause (i) or (ii).

D. 2014 report of the Joint Committee on Taxation - Background and Data with Respect to Hedge Fund Reinsurance Arrangements

In 2014, the Joint Committee on Taxation released a report entitled "Background and Data with Respect to Hedge Fund Reinsurance Arrangements" (the "JCT Report") addressing the United States tax issues associated with "hedge fund reinsurance".

The JCT Report first summarizes how the use of "hedge fund reinsurance" results in favorable tax treatment, and notes coverage in the popular press of the use of hedge fund reinsurance to avoid tax.[40] The tax benefits, summarized by the JCT Report, are (i) indefinite deferral of United States taxation of the hedge fund's investment earnings, and (ii) taxation of investment income at capital gains rates rather than at ordinary investment income rates.

The JCT Report then summarizes some common features of hedge fund reinsurance. Specifically the JCT Report identifies the following characteristics:

- Formation of a new foreign reinsurance company in a low-tax offshore jurisdiction;
- Assumption by the foreign reinsurance company of risks originally underwritten by other insurance companies;
- Capitalization of the reinsurer by a United States hedge fund or by the hedge fund's investors and managers; and

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[39] H.R. 1, 113th Cong., 2d Sess., § 3703 (Feb. 21, 2014).

[40] *See*, *e.g.*, Victor Fleischer, "Why Hedge Funds Don't Worry About Carried Interest Tax Rules," *New York Times*, Dealbook, May 14, 2014.

- Investment by the foreign reinsurer in the hedge fund.

The JCT Report ascribes to such a hedge fund reinsurance company an intent to conduct its business in a manner which is consistent with the business needs of the hedge fund. Specifically,

- The investment of the reinsurer's reserves in the United States hedge fund retains capital in the hedge fund while minimizing the risk that the investor will withdraw large amounts unexpectedly, if the reinsurer and its owners are related to the hedge fund or are seeking hedge fund investment returns.

- The investment by the reinsurer of large sums with the hedge fund is consistent with the assumption by the reinsurer of risks that by their nature are unpredictable or difficult to model, and that would give rise to a very large loss if they were to occur, such as catastrophe risks. The assumption of such risk can be used to justify holding exceptionally large reserves and the assets to back them up.

- Hedge fund reinsurance companies may also assume risks that are predictable and not difficult to model, such as life risks, which can be made to "dovetail" with the hedge fund's investment strategy.

- Having the hedge fund reinsurance company invest in more risky types of assets may also be used to justify holding exceptionally large reserves, to compensate for the higher volatility or riskiness of the investments.

The JCT Report assumes that hedge fund reinsurance is generally structured to avoid the subpart F and PFIC anti-deferral regimes. Subpart F is avoided by keeping United States investors below the 10 percent voting threshold.[41]

The JCT Report notes the exception from PFIC status for income derived in the active conduct of an insurance business, describing Notice 2003-34. The JCT Report also notes that on June 12, 2014, Senator Ron Wyden, Chairman of the Senate Committee on Finance, sent a letter to Treasury and the Service "inquiring why no progress had been made in ending the 'tax abuse' identified with respect to hedge fund reinsurance in Notice 2003-34."

E. 2015 Proposed PFIC Regulations

In June of 2015 the Service issued proposed regulations 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).[42]

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[41] The Act amended section 951(b) to provide that a United States person is a United States shareholder if it owns 10 percent of the stock by vote or value, so beginning in 2018 a United States person may no longer avoid subpart F by limiting voting rights to less than 10 percent while owning 10 percent or more by value.

[42] Prop. Reg. § 1.1297-4, 80 Fed. Reg. 22,954 (2015).

The preamble to the proposed regulations states that Treasury and the Service have become aware of situations "in which a hedge fund establishes a purported foreign reinsurance company in order to defer and reduce the tax that otherwise would be due with respect to investment income."[43]

Although the preamble refers to potentially tax-abusive "hedge fund reinsurance", the proposed regulations are described not as being targeted specifically at tax abuses, but rather as an attempt to "clarify the circumstances under which investment income earned by a foreign insurance company is derived in the active conduct of an insurance business" because "active conduct" and "insurance business" are not defined in the Code.

The proposed regulations provide that the term "active conduct" has the same meaning as in Regulation section 1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities.[44]

Regulation section 1.367(a)-2T(b)(3) states that a corporation actively conducts a trade or business only if the officers and employees carry out "substantial managerial and operational activities."

The proposed regulations define the term "insurance business" to mean the business activity of issuing insurance and annuity contracts and the reinsuring 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.[45] The regulations also 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).[46] The proposed regulations further provide 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 contracts.[47]

The proposed regulations do not set forth a method to determine the portion of assets held to meet obligations under insurance and annuity contracts. Comments are requested on appropriate methodologies for determining the extent to which assets are held to meet obligations under insurance and annuity contracts.

[43] 80 Fed. Reg. 22,954 (2015)

[44] Prop. Reg. § 1.1297-4(b)(1).

[45] Prop. Reg. § 1.1297-4(b)(2) (2015).

[46] Prop. Reg. § 1.1297-4(b)(2)(i) (2015).

[47] Prop. Reg. § 1.1297-4(b)(2)(ii) (2015).

F. Wyden Proposal

On June 25, 2015, Senate Finance Committee Chairman Ron Wyden released the text of the Offshore Reinsurance Tax Fairness Act (the "Wyden Bill"). The Wyden Bill was intended to curtail certain abuses believed to arise when an asset manager forms an offshore reinsurance company that invests in the funds managed by the asset manager, with the intent of deferring United States tax on the income of the reinsurer.

Specifically, the Wyden Bill proposed to amend the exception from PFIC status for insurance companies by adding a new requirement that the insurance company be a "qualifying insurance corporation."

The changes to section 1297(f) proposed in the Wyden Bill were essentially identical to the changes in the Act, the only difference being that the term "applicable financial statement" was defined as a statement for financial reporting purposes that (a) is made on the basis of United States GAAP, (b) is made on the basis of international accounting standards (IAS) (rather than based on IFRS as stated in the Act) but only if no United States GAAP statement is available, or (c) except as otherwise provided by new Treasury regulations, the annual statement that is required to be filed with the applicable insurance regulatory body, but only if there is no statement in accordance with United States GAAP or IAS.

The Wyden Bill also provided for an alternative test if a foreign corporation fails to qualify as a qualifying insurance corporation solely because the ratio of insurance liabilities to total assets was less than 25 percent, the only difference being that a United States person could elect to apply the lower 10% ratio if the failure to meet the 25% ratio was due solely to "temporary circumstances," rather than specifically identifying "runoff-related" or "rating-related circumstances.