September 9, 2019

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

Re: Proposed Regulations under Section 1297 with respect to PFICs

Dear Commissioner Rettig:

Enclosed please find comments regarding Proposed Regulations under Section 1297 of the Internal Revenue Code on the Qualifying Insurance Corporation Exception for Passive Foreign Investment Company ("PFIC") Purposes. 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. Accordingly, they should not be construed as representing the position of the American Bar Association.

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

Sincerely,

[Signature]

Tom Callahan
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
Lafayette G. "Chip" Harter III, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
Douglas L. Poms, International Tax Counsel, Department of the Treasury
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Lindsay Kitzinger, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
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AMERICAN BAR ASSOCIATION SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 1297 ON THE QUALIFYING INSURANCE CORPORATION EXCEPTION FOR PFIC PURPOSES

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, Revital Gallen, Kristen Hazel, and Surjya Mitra. They have been reviewed by Eric Solomon of the Committee on Government Submissions and Eric Sloan, Vice Chair, Government Relations.

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: September 9, 2019
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I. EXECUTIVE SUMMARY


We want to express our appreciation to Treasury and the Service for their guidance on a number of difficult issues under section 1297 and the invitation for taxpayer comments on many specific issues. In many cases, we agree with the positions taken in the Proposed Regulations.

To the extent that there is an overarching theme to the Proposed Regulations, we perceive that theme to be that in the interests of clarity and administrability, Treasury and the Service have sought to create rules that are bright-line tests, such as the determination of applicable insurance liabilities based on an applicable financial statement, or the creation of an “active conduct percentage” to determine if an insurance company is predominantly engaged in the active conduct of an insurance business. However, as discussed further below, the variations within the insurance industry for different types of risks and lines of business may make it difficult to apply a bright-line test in a way that would be equitable to foreign insurance companies that are real insurance companies that do not appear to be the kind of companies to which section 1297(f) seems to be directed.

The following is a summary of our Comments on the specific issues on which comments were invited, and other areas where we believe that comments are appropriate.

We recommend the following revisions to the Proposed Regulations:

- We recommend that the Proposed Regulations should be revised to provide that section 954(i), which excludes certain income derived in the active conduct of an insurance business from treatment as foreign personal holding company income (“FPHCI”), should apply in addition to the exception in section 1297(b)(2)(B), which excludes income derived in the active conduct of an insurance business by a qualifying insurance corporation (“QIC”) from treatment as passive income for PFIC purposes.

- We recommend that the Proposed Regulations make clear that there is no “tracing” or “tracking” requirement based on the “required to support” and “substantially related” phrases in Prop. Treas. Reg. § 1.1297-5(c)(2) that would require an insurance company to prove that its investment income is specifically attributable to the insurance business. If Treasury and the Service did not intend to

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2 Unless otherwise indicated, all section references are to the Code or to regulations promulgated thereunder.
impose such a tracing or tracking requirement, we would propose eliminating the phrases “required to support” and “substantially” so that the phrase would read: “. . . together with those investment activities and administrative services that are related to those insurance, annuity, or reinsurance contracts issued or entered into by the QIC.”

- We recommend eliminating the “active conduct percentage” determination.

- We recommend that insurance business activities contracted for and paid for by a QIC should be counted towards active conduct regardless whether these activities are conducted by a party that is related by ownership to, or independent of, the QIC.

- We recommend that the wording of Prop. Treas. Reg. § 1.1297-4(d)(2)(i) be revised to make clear that even if the “more than half” test is met, a foreign corporation will not be considered as predominantly engaged in an insurance business unless it meets the facts and circumstances test.

- We recommend that Treasury and the Service reconsider the language of the Proposed Regulations that applies the “facts and circumstances” test based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm’s length transactions, since this expression of the test is unclear.

- We recommend that the Proposed Regulations be revised to make clear that the facts and circumstances listed are relevant to whether the foreign corporation is predominantly engaged in an insurance business, but that the list is not exclusive and that other facts and circumstances, including but not limited to the fact that the company is regulated as an insurance company, may also be taken into account.

- We recommend that final regulations remove the requirement that a runoff company have a plan of liquidation, and the requirement that amounts paid by the runoff company cause the corporation to fail to satisfy the 25 percent test.

- We recommend the clarification of a number of ambiguities in the regulatory language with respect to rating-related circumstances, including:
  - Clarification as to who is required to “classify” an insurance company as “secure to write new business” based on a higher level of capital;
  - Clarification of what it means for an insurance company to be “secure to write new insurance business”; and
  - Clarification of the meaning of the phrase “highest minimum credit rating required”.
We recommend that Treasury and the Service clarify whether a foreign corporation must reapply the “rating-related circumstances” test every year and, if the intent is for the test to be reapplied, we recommend a standard that the test does not need to be reapplied unless there is a change in circumstances.

We recommend an approach which allows shareholders to rely on a statement from a foreign corporation as to its PFIC status, except if the shareholder has actual knowledge that the statement is incorrect.

We recommend clarification of the meaning of the word “minimum” as used in the phrase “minimum amount of applicable insurance liabilities” in Prop. Treas. Reg. § 1.1297-4(e)(2)(ii).

We recommend that Treasury and the Service conform Prop. Treas. Reg. § 1.1297-4(f)(2) defining “applicable insurance liabilities” to better align with the computation of insurance company taxable income as set forth in section 832 and, in particular, revise Prop. Treas. Reg. § 1.1297-4(f)(2)(i) to reference “incurred losses” rather than “occurred losses” and delete the requirement that there have been a determination of liability.

Because the limitation on “applicable insurance liabilities” based on a GAAP or IFRS statement that is not an applicable financial statement is unworkable, we recommend that requirement be removed. Otherwise, we recommend that Treasury and the Service define “financial statement” and “financial reporting purposes.”

Because the rule restricting a taxpayer’s choice of accounting standards is inconsistent with commonly accepted principles of United States tax law, we recommend that Treasury and the Service remove the rule that a taxpayer may not change its accounting standard unless it can demonstrate a non-Federal tax business purpose.

We recommend that Treasury and the Service replace the reference to “occurred losses” in Prop. Treas. Reg. § 1.1297-4(f)(2)(i) with a reference to “losses” or to “incurred losses within the meaning of section 832(b)(5).”

We recommend that the rules governing the interaction between the general look-through rule, the domestic subsidiary look-through rule, and qualifying domestic insurance companies be changed so that minority shareholders will not be treated as shareholders in a PFIC subsidiary of a foreign holding company solely because of the rules relating to qualifying domestic insurance companies.

Due to the number and complexity of the issues addressed in the Proposed Regulations, we suggest that the Treasury and Service, after reviewing the comments submitted on the Proposed Regulations, consider issuing a second round of Proposed Regulations.
II. DISCUSSION

A. Comments on interaction between section 954(i) and section 1297(b)(2)(B)

The Proposed Regulations provide that section 954(i), which excludes certain income derived in the active conduct of an insurance business from treatment as FPHCI, should not apply in addition to the exception in section 1297(b)(2)(B), which excludes income derived in the active conduct of an insurance business by a QIC from treatment as passive income for PFIC purposes. The rationale for this rule offered by Treasury and the Service in the preamble to the Proposed Regulations is that:

Congress recently amended the exclusion for income derived in the active conduct of an insurance business in section 1297(b)(2)(B) to require that income be earned by a QIC.... Given this statutory change and the tests contained in the definition of QIC in section 1297(f), the Treasury Department and the IRS have determined that the exception for insurance income in section 954(i) should not apply in addition to the newly modified exception in section 1297(b)(2)(B).

By contrast, the Proposed Regulations provide that the exception from treatment as FPHCI for banking and financing income under section 954(h) continues to apply for purposes of determining PFIC status, because there are no final regulations under the PFIC regime concerning an exclusion of active banking and financing income.3

Generally, the term passive income for purposes of the PFIC rules means income of a kind that would be FPHCI as defined in section 954(c)(1). Section 954(i) provides an exception from FPHCI for investment income up to a certain amount (the “active financing exception”).

While section 954(i) by its terms applies only for purposes of determining the FPHCI of a controlled foreign corporation (“CFC”), Prop. Treas. Reg. § 1.1297-1(c)(1)(i)(D) provides, inter alia, that an entity is treated as if it were a CFC for purposes of applying an exception to FPHCI in section 954(c) and (h).

However, there appears to be little reason why the amendment of section 1297(b)(2)(B) by Congress in 2017 should require that section 954(i), which was enacted in 1998,4 no longer apply for purposes of determining whether income is FPHCI and therefore passive income for PFIC purposes. The exclusions of income from treatment as passive income under section 1297(b)(2)(B) and section 954(i) are directed at different fact patterns. Section 954(i) is directed at income derived by a foreign corporation engaged in an active insurance business, and mainly insuring unrelated party risks located in its home country. By contrast, section 1297(b)(2)(B) is directed at foreign insurance companies that may have little or no presence in their home country, and that may cover related party risks and/or United States risks so long as the


applicable insurance liabilities of such foreign corporations are in excess of 25% of their total assets.

Generally, in order for a foreign corporation to qualify for the active financing exception of section 954(i), the corporation must be predominantly engaged in the insurance business and conduct substantial activity with respect to such business. In addition, certain nexus requirements apply, which provide that income derived by the foreign corporation from transactions with customers is eligible for the exception if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the foreign corporation in its home country and such income is treated as earned by the foreign corporation in its home country for purposes of such country’s tax laws.\(^5\)

Further, the amount of investment income that is excluded from FPHCI under the active financing exception of section 954(i) is limited, and is generally based on certain assets and reserves of the CFC.\(^6\) For example, the exception applies to income derived from investment of assets equal to 10% of reserves for life insurance or annuity contracts regulated in the country in which sold, but does not apply to investment income with respect to excess surplus.\(^7\)

It does not appear that the foreign corporations whose income would qualify for the active financing exception are of the type that are targeted by the PFIC rules. Such foreign corporations are actively operating an insurance business with a substantial presence in their home country. Therefore, to the extent that the foreign corporation meets all the requirements included in section 953(e)(3) to be treated as a qualifying insurance company, the exception under section 954(i) should remain available to it to exclude certain income from FPHCI for purposes of determining PFIC status.\(^8\)

Situations where section 1297(b)(2)(B) and section 954(i) may interact are limited to situations where the applicable insurance liabilities do not satisfy the 25% test (or are below 10% in the event that the alternative facts and circumstances test applies). In such cases, the foreign corporation fails the PFIC insurance exception and its PFIC status is tested based on the general rules (the income test and assets test). The amount of income (or assets) that may be excluded from FPHCI under section 954(i) in such scenarios would be very small, because it is computed

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5 See sections 954(i)(1), 953(e)(3) and 953(e)(2). In general, section 953(e)(2) and 953(e)(3) further provide that the risks taken into account are (1) not United States risks and (2) are risks with respect to which no policyholder, insured, annuitant, or beneficiary is a related person (as defined in section 954(d)(3)).

6 See sections 954(i)(2)(A) and (B).

7 See “General Explanation of Tax Legislation Enacted in 2002,” prepared by the staff of the Joint Committee on Taxation, January 24, 2003, JCS 1-03, at 281.

8 The Proposed Regulations in effect amend section 1297(b)(1), in conjunction with section 954(c) and section 954(i), to provide that for purposes of the PFIC rules, “passive income” is FPHCI as defined in section 954(c), but without regard to section 954(i). Although Congress amended section 1297(b)(2)(B), it did not amend section 1297(b)(1), nor did Congress express any intent to change the meaning of section 1297(b)(1) without changing its language.
based on the amount of certain assets and reserves of the foreign insurance corporation as discussed above.

Allowing the exception from FPHCI under section 954(i) would produce a very limited benefit but should be allowed because it is not in conflict with section 1297(b)(2)(B) or the policy behind the PFIC rules. Allowing the exception under section 954(i) to apply would generally not affect the PFIC status of the foreign insurance corporation itself because the amount of the investment assets/income excluded under section 954(i) would probably be below the required percentages when applying the income test and/or asset test. However, for the reasons stated above it should be taken into account when testing the PFIC status of a higher-level foreign corporation that owns an interest in the foreign insurance corporation.

B. Comments on the “active conduct” test

1. Exemption from passive income

Section 1297(b)(2)(B) provides that passive income does not include any income that is derived in the active conduct of an insurance business by a QIC. Under the Proposed Regulations, passive income does not include income that a QIC derives in the active conduct of an insurance business, as defined in Prop. Treas. Reg. § 1.1297-5(c).\footnote{Prop. Treas. Reg. § 1.1297-5(c).} Under the Proposed Regulations, an insurance business is defined as “the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC.”\footnote{Prop. Treas. Reg. § 1.1297-5(b)(1).}

The inclusion within the definition of “insurance business” of only investment activities that are “required to support (or that are substantially related to)” insurance, annuity or reinsurance contracts introduces an ambiguity to the Proposed Regulations which should be resolved by Treasury and the Service. This additional language could be read to mean that investment income of the company that exceeds the minimum amount that is required to meet the insurance company’s obligations under insurance, annuity, or reinsurance contracts should be treated as passive income. If this was the intent of Treasury and the Service, this language is problematic because the Proposed Regulations provide no standard to determine the extent to which investment income exceeds the minimum amount required to meet the company’s obligations. It should be presumed that investment activities conducted by a QIC engaged in the active conduct of an insurance business are performed to support the insurance, annuity, and reinsurance contracts and insurance business of the QIC.

If it was not the intent of Treasury and the Service to impose this additional condition on treating investment income as non-passive income, the requirement that investment activities be
“required to support” or be “substantially related to” the insurance business introduces unnecessary uncertainty.

Accordingly, we propose that the Proposed Regulations make clear that there is no tracing or tracking requirement based on the “required to support” and “substantially related” phrases in Prop. Treas. Reg. § 1.1297-5(c)(2) that would require an insurance company to prove that its investment income is specifically attributable to the insurance business. If Treasury and the Service did not intend to impose such a tracing or tracking requirement (which, we note, would be overlaid on the other requirements imposed by the Proposed Regulations, most notably the “active conduct percentage” discussed further below), we would propose eliminating the phrases “required to support” and “substantially” so that the phrase would read: “. . . together with those investment activities and administrative services that are related to those insurance, annuity, or reinsurance contracts issued or entered into by the QIC.”

2. The “active conduct percentage” test

As mentioned above, section 1297(b)(2)(B) provides that passive income does not include any income that is derived in the active conduct of an insurance business by a QIC. The Proposed Regulations introduce an entirely new requirement that must be met in order for income of a QIC to be treated as non-passive income. Under Prop. Treas. Reg. § 1.1297-5(c)(1), income of a QIC derived in the active conduct of an insurance business will be treated as entirely passive income unless the company’s “active conduct percentage” equals or exceeds 50 percent.

The active conduct percentage is defined as the percentage calculated by dividing (i) the “aggregate amount of expenses, including compensation (or reimbursement of compensation) and related expenses, for services of the officers and employees of the QIC” (or of a related entity that satisfies a control test) that are “related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into” by the QIC, by (ii) the sum of the amount described in clause (i) above, and the amount of all expenses paid for the taxable year by the QIC to a person other than a person whose services for the QIC are covered by the expenses included in clause (i) above “for the production or acquisition of premiums and investment income on assets held to meet obligations under the insurance, annuity, or reinsurance contracts issued or entered into” by the QIC.11

The concept of an “active conduct percentage” is not found anywhere in the Code. The Joint Committee on Taxation’s explanation of 2017 tax reform12 does not define, or refer to, an active conduct percentage. As the 2017 Tax Reform Blue Book explains, the new section 1297(f) provision “replaces the test based on whether a corporation is predominantly engaged in an insurance business with a test based on the corporation’s insurance liabilities”;13 no mention is

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12 Joint Committee on Taxation, General Explanation of Public Law 115-98 (December 2018) (hereinafter “2017 Tax Reform Blue Book”).

made of a new active conduct test. Accordingly, we respectfully question the advisability of imposing this additional, bright-line test.

The definition of “active conduct percentage” has numerous ambiguities and, depending on how those ambiguities are resolved, would impose on foreign insurance companies seeking to avoid PFIC status conditions and requirements that no domestic insurance company was ever required to meet.

Omitting extraneous or incidental language, the numerator of the active conduct percentage is defined as:

expenses, including compensation…, for services of the officers and employees of the QIC … incurred by the QIC … that are related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC.

This passage could easily be read in at least two ways. One interpretation is that the numerator is defined as “expenses … that are related to the production or acquisition of premiums and investment income.” This would be the interpretation most generous to taxpayers, since it would allow taxpayers to include in the numerator all expenses related to the production or acquisition of premium and investment income, not just compensation paid to officers and employees of the QIC. However, even this interpretation is problematic, because the phrase “related to” suggests that some expenses incurred by a QIC may somehow not be “related to” the production or acquisition of premium and investment income. The Proposed Regulations provide no guidance as to how to determine whether expenses are “related to” premium and investment income. It should be presumed that all expenses incurred by an insurance company (including for example the cost of renting office space, the cost of support staff, etc.) are related to the insurance company’s business, i.e., “the production or acquisition of premiums and investment income”.

A second interpretation is that the numerator is defined as “expenses … for services of the officers and employees of the QIC [or a related party] … that are related to the production or acquisition of premiums and investment income.” This interpretation raises all the same concerns as are described above with respect to the first interpretation, with the additional shortcoming that it would seem to exclude from the numerator all expenses incurred by the insurance company other than “expenses … for services of the officers and employees of the QIC.” The rule would thus exclude from the numerator expenses that should be unobjectionable (such as rent or other costs of maintaining office space) and which would, depending on how the denominator is calculated, result in an artificially low active conduct percentage.14

14 The Proposed Regulations state that the numerator includes expenses for services of the officers and employees of the QIC “including compensation”. The phrase “including compensation” implies that it may be permitted to include in the numerator expenses “for services of the officers and employees” that are not compensation, but it is not clear what expense there could be “for services of the officers and employees” that is not “compensation.” An obvious ambiguity in the Proposed Regulations is whether deferred compensation should be included in the numerator, and how the numerator would be calculated.
This proposed rule bears some resemblance to the 2015 proposed regulations under section 1297(b)(2)(B), which permitted only activities of officers and employees of the insurance company itself to be taken into account in determining whether the insurance company was engaged in the active conduct of an insurance business, but the new Proposed Regulations set a much higher threshold. Under the 2015 proposed regulations, an insurance company might outsource some insurance company functions (such as investment management, which is quite common even among large domestic insurance and reinsurance companies) and still be considered to be engaged in the active conduct of an insurance business. Under the Proposed Regulations, even perfectly ordinary outsourcing of some functions of an insurance company may jeopardize the ability of the company to exclude its income from being treated as being passive income.

The definition of the denominator of the active conduct percentage is also unclear. The definition of the denominator could be read to mean all expenses included in the numerator plus either (i) all expenses paid to unrelated parties, or (ii) all expenses paid to related or unrelated parties that are not for the production or acquisition of premiums and investment income.

Moreover, other adequate tests of passivity and safeguards against a non-insurance company claiming the insurance exception to PFIC status are already in place in the QIC test in section 1297(f) and the other provisions of the Proposed Regulations. In light of these observations, we suggest that superimposing a new, complex determination of a QIC’s “active conduct percentage” to be made by a United States shareholder of a foreign insurance company—who may have little or no access to the granular expense information of a QIC in which it is a shareholder—will not serve to enhance compliance with section 1297(f), but rather would merely increase compliance burdens for United States shareholders of foreign insurance companies without yielding the intended result of appropriately classifying “non-active” insurance company income as passive for purposes of determining a foreign insurance company’s PFIC status. Accordingly, we respectfully suggest eliminating the “active conduct percentage” determination.

If the “active conduct percentage” in Prop. Treas. Reg. § 1.1297-5(c)(4) is retained, we propose that the “active conduct percentage” test might prove useful as a safe harbor, i.e., a company that met the active conduct percentage test would be treated as engaged in the active conduct of an insurance business without regard to any subjective test. We would also suggest adding an alternate, facts and circumstances-based standard, similar to the alternative facts and circumstances test of section 1297(f)(2) which permits an insurance company to qualify as a QIC even if its applicable insurance liabilities are less than 25% of its assets. We would suggest, however, that an entity’s failure to meet the 50% active conduct percentage could be due to any practical business reason or fact elaborated by the QIC rather than being tied to specific enumerated reasons, e.g., rating or run-off related reasons, such that various facts and circumstances could be cited to support an insurance company’s eligibility for this alternate standard. We suggest Treasury and the Service take into consideration that application of the active conduct percentage in its current, all-or-nothing form would have a harsh and possibly unwarranted cliff effect for a QIC that does not produce at least a 50% active conduct

\[\text{Proposed Treas. Reg. § 1.1297-4(b)(1).}\]
percentage. We note also that application of the active conduct percentage without change would potentially result in over-characterization of passive income, and would potentially result in treatment of many United States-based insurance companies that conduct foreign insurance operations as PFICs.16

3. Active conduct of an insurance business

Prop. Treas. Reg. § 1.1297-5(c)(4) confines “active conduct” of an insurance business to situations in which the officers and employees of the QIC (or of a related entity if the control test, discussed below, is met) carry out “substantial managerial and operational activities.” We commend Treasury and the Service for improving upon the 2015 proposed regulations by allowing for the possibility of active conduct of an insurance business in situations where substantial activities are performed by officers and employees of an entity other than the QIC itself. Acknowledging that insurance companies may house shared services in a related entity, or may have employees or officers of related companies perform various core insurance business activities such as underwriting, claims handling, or investment-related activities, more closely aligns the Proposed Regulations with market reality than the 2015 proposed regulations and, thus, helps reduce the risk that an otherwise legitimate and active insurance company would fail the “active conduct” test.

Yet in determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, Prop. Treas. Reg. § 1.1297-5(c)(3)(i) excludes from consideration the activities of independent contractors. This exclusionary rule doesn’t make allowance for an important additional market reality: in an era of industry consolidation, cost-cutting, and the rise of fintech companies, many otherwise active, and even legacy, insurance companies outsource certain insurance business functions to trusted professionals who are unrelated to the QIC or related to the QIC but do not meet the required ownership percentage—including, for example, investment managers and investment advisors.

Through imposition of the control test, Treasury’s and the Service’s pragmatic expansion in Prop. Treas. Reg. § 1.1297-5(c)(3), beyond the confines of the 2015 proposed regulations, of the pool of professionals who may perform active insurance activities, i.e., individuals other than employees and officers of the QIC itself, is too narrow. For activities of an employee or officer of an entity other than the QIC to count for purposes of the active conduct test and be attributable to the QIC, the QIC must satisfy the control test in Prop. Treas. Reg. § 1.1297-5(c)(3)(ii). The first prong of the control test, ownership, can be satisfied if either (1) the QIC owns (or is considered to own under section 958(a)) more than 50% of the total vote and more than 50% of the total value of the stock in the corporation whose officers and employees perform insurance business activities for the QIC, or (2) a common parent owns (or is considered to own under section 958(a)) more than 80% of the total vote and more than 80% of the total value in both the

16 The qualified insurance company exception is designed to address concerns by legislators and the Service about operations of pure investment vehicles disguised as offshore insurance companies. See, e.g., IRS Notice 2003-34, 2003-1 C.B. 990. Please refer to the Appendix to our previous ABA Tax Section letter from Eric Solomon to Charles Rettig dated January 3, 2019 for a summary of the history behind the QIC provisions. Considering the original, intended targets of this provision, we would ask Treasury and the Service to devise a rule that avoids capturing legitimate insurance companies.
QIC and the corporation that performs activities for the QIC.\textsuperscript{17} We propose that insurance business activities contracted for and paid for by a QIC should be counted towards active conduct regardless whether these activities are conducted by a party that is related by ownership to, or independent of, the QIC.\textsuperscript{18}

We understand Treasury’s and the Service’s desire to provide certainty to taxpayers and simplicity of administration with a bright-line, quantitative rule for whether the income of a QIC is passive or non-passive. In essence, insurance-related services that are performed for a QIC by persons who are not employees or officers of the QIC or a related party that meets the control test are not considered as contributing to the active conduct of an insurance business. This criterion for qualifying as engaging in the active conduct of an insurance business, however, may cause even some commercial insurance companies to fail the “active conduct” test—as mentioned above, it is fairly common practice for commercial insurance companies to outsource various core operational activities, \textit{e.g.}, administrative tasks performed by a third-party administrator or investment functions performed by a third-party investment manager and/or asset manager. Whether a QIC employs the services of a related or unrelated person to conduct its asset management and advisory activities should not affect whether the investment income of the QIC is passive or non-passive.

Moreover, measuring active insurance income by comparing expenditures on related party services to all expenditures may not be the most accurate way to identify non-active insurance companies. The QIC test itself focuses on liabilities. Comparing relative amounts of insurance and reinsurance premiums, net investment income, and insurance liabilities would possibly provide a more balanced picture of a QIC’s insurance business than the “active conduct percentage” as currently defined in Prop. Treas. Reg. § 1.1297-5(c)(4)(i)(A)-(B).

\textbf{C. Comments on the application of the alternative facts and circumstances test}

1. Facts and circumstances test generally

The Proposed Regulations provide guidance regarding the circumstances under which a foreign corporation is considered predominantly engaged in an insurance business for purposes of section 1297(f)(2). There are a number of ambiguities in the Proposed Regulations relating to whether a foreign corporation is “predominantly engaged in an insurance business” which we recommend be resolved in final regulations.

The first sentence of Prop. Treas. Reg. § 1.1297-4(d)(2)(i) states that “A foreign corporation is predominantly engaged in an insurance business in any taxable year during which more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.” This is a quantitative


\textsuperscript{18} We do not have comments on the requirement in Prop. Treas. Reg. § 1.1297-5(c)(3)(ii)(B) that the QIC exercise regular oversight and supervision of services performed in furtherance of the insurance business of the QIC. Nor do we have comments on the compensation prong of the control test in Prop. Treas. Reg. § 1.1297-5(c)(3)(ii)(C). Both of these elements of the control test appear reasonable, if not extensively defined.
test which, on its face, admits of no qualification or caveat that suggests that a foreign corporation that meets this test might nevertheless not be treated as “predominantly engaged in an insurance business,” nor is there any language later in the regulation which would qualify this statement, such as “notwithstanding the foregoing...”.

The wording of Prop. Treas. Reg. § 1.1297-4(d)(2)(i) is clearly not what was intended by Treasury and the Service, since, as noted above, the proposed regulation admits of no qualification or exception and therefore renders the latter part of the regulation that addresses the facts and circumstances test irrelevant. Perhaps what was intended, and the regulation could be revised to read, “A foreign corporation will not be considered predominantly engaged in an insurance business in any taxable year unless more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies” (emphasis added). This will preserve the desired reiteration of the “more than half” test while also making clear that even if the “more than half” test is met, a foreign corporation will not be considered as predominantly engaged in an insurance business unless it meets the facts and circumstances test.

The second sentence of Prop. Treas. Reg. § 1.1297-4(d)(2)(i) states that “This determination [i.e., the determination that more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies] is made based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm’s length transactions.”

It is unclear how Treasury and the Service intend that a qualitative test (whether the “facts and circumstances of the foreign corporation” are comparable to arm’s length insurance transactions between unrelated parties) be applied to the quantitative “more than half” test. If the intent is that insurance transactions that do not meet the arm’s length test would somehow be excluded from the calculation of whether more than half of the business of the foreign corporation is related to insurance or reinsurance, there is no guidance as to how that calculation would be done.

It is also unclear how Treasury and the Service intend that the “particular facts and circumstances” of the foreign corporation might be compared to commercial insurance arrangements that satisfy the arm’s length standard. Perhaps the intent is to require that the insurance business of the foreign company be conducted in a manner comparable to that of other commercially viable insurance companies (a standard similar, for example, to the “commonly accepted notion of insurance” concept enunciated in Helvering v. LeGierse\(^ {19} \) and Harper Group v. Commissioner\(^ {20} \)). If this is the intent of Treasury and the Service, the regulations should so state. The standards enunciated in LeGierse, Harper and other cases pertinent to the “commonly accepted notion of insurance” would provide more clarity than the language in the Proposed Regulations as currently written.

\(^ {19} \) 312 U.S. 531 (1941).

\(^ {20} \) 96 T.C. 45 (1991), aff'd, 979 F.2d 1341 (9th Cir. 1992).
For foreign corporations that enter into insurance transactions only with unrelated parties, the transactions are by definition consistent with the arm’s length principle, and therefore characterizing foreign corporations as predominantly engaged, or not predominantly engaged, in the insurance business by reference to the arm’s length principle makes little sense. For foreign corporations that enter into transactions with related parties, such as captives, the arm’s length principle is relevant for transfer pricing purposes, but adds little to the determination of whether the corporation is predominantly engaged in an insurance business, since (i) the fact that a corporation is subject to a transfer pricing adjustment does not in and of itself mean that the corporation is not engaged in business, and (ii) an insurance company that does business solely with related parties is subject to a body of case law which goes to the question of whether the transactions entered into by the company are insurance for tax purposes, and whether the company is an insurance company for tax purposes, which are questions that are more fundamental than the question of whether the corporation is “predominantly engaged” in the insurance business.

The third sentence of Prop. Treas. Reg. § 1.1297-4(d)(2)(i) states that “The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative of whether the foreign corporation is predominantly engaged in an insurance business”. It seems uncontroversial that the fact that a corporation “holds itself out” as an insurer should not by itself be “determinative” of whether it is predominantly engaged in an insurance business. However, whether a company “holds itself out as” an insurance company should certainly be relevant to whether the company is treated as an insurance company for tax purposes, which is in turn relevant to whether the company is engaged in insurance business.

Furthermore, there is ambiguity in the phrase “holding itself out as an insurer.” Whether a company “holds itself out as an insurer” in the sense of advertising itself as an insurer should be given very little weight. On the other hand, whether the company is regulated as an insurance company should be considered highly relevant to whether the company should be treated as an insurance company.

The problem with the language relating to whether the company “holds itself out as an insurer” is not that that fact should in any way be determinative of whether a company should be treated as predominantly engaged in the insurance business, but rather that the overall structure of the Proposed Regulations suggests that that fact, as well as other “facts and circumstances” traditionally taken into account in determining whether a company is treated as an insurance company for tax purposes cannot, under the Proposed Regulations, be taken into account at all.

This is because Prop. Treas. Reg. § 1.1297-4(d)(2)(ii) provides a list of facts and circumstances “to consider in determining whether a foreign corporation is predominantly engaged in an insurance business.” The wording implies that these are the only factors that may be taken into account. The preamble to the Proposed Regulations justifies inclusion of these facts and circumstances on the grounds that these are “specific factors enumerated in the legislative history” that are relevant to whether a foreign corporation is predominantly engaged in an insurance business.


insurance business. However, the legislative history makes clear that this is a non-exclusive list of facts and circumstances that would tend to show that a company is predominantly engaged in the insurance business; the phrasing of the Proposed Regulations suggest that the list is an exclusive list. Accordingly, we recommend that the Proposed Regulations be revised to make clear that the facts and circumstances listed are relevant to whether the foreign corporation is predominantly engaged in an insurance business, but that the list is not exclusive and that other facts and circumstances, including but not limited to the fact that the company is regulated as an insurance company, may also be taken into account.

2. Runoff-related circumstances

The standard set forth in the Proposed Regulations related to whether a company may qualify as a QIC under the alternative facts and circumstances test because of runoff-related circumstances is inconsistent with prevailing commercial practice in the insurance industry.

A “runoff” insurance company is a company that “is not taking on new insurance business (and consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books.” However, it would be a mistake to assume that a company in “runoff” is a company that is “actively engaged” in the process of liquidating, as the Proposed Regulations suggest. A company in runoff is still generally considered to be engaged in the insurance business (as the Code itself implies, since a company that is entitled to apply the alternative facts and circumstances test due to runoff-related circumstances is still required to be predominantly engaged in an insurance business). Runoff companies still receive a rating agency rating, and are “evaluated similarly to other insurers.” Runoff carriers are often part of a larger insurance group, and the management of the runoff business is not a prelude to liquidation, but is a way for the active insurance businesses to shift their core business segments and maximize their use of capital. Some companies (known as “runoff specialists”) are in the business of acquiring reserve liabilities to “profitably manage the settlement and payout of claims until all of the liabilities are exhausted.”

The first requirement in the Proposed Regulations is that the runoff company be “actively engaged in the process” of terminating or liquidating, and that it have adopted a plan of liquidation or termination under the supervision of the insurance regulator. However, no runoff company is “actively engaged in the process” of terminating or liquidating: a runoff company is

23 See, e.g., 2017 Tax Reform Blue Book, at 412 (facts and circumstances that are relevant to whether a company is predominantly engaged in the insurance business “include” the factors listed).


actively engaged in the management of its remaining liabilities. In the case of some long-tail business, a runoff company could continue to manage its remaining liabilities for years.\textsuperscript{28} Furthermore, there is no prevailing practice in the insurance industry for a regulator to supervise a plan of liquidation or termination of a runoff company.

The company described in the Proposed Regulations as a “runoff company” is not in fact a runoff company, it is a company in liquidation. There is no basis for the conclusion that Congress intended, when using the term “runoff”, to limit the availability of the alternative facts and circumstances test to companies that were actively liquidating or terminating.

Equally problematic is the third element of the test for whether a company failed to satisfy the 25 percent test solely due to runoff-related circumstances, which is that the company must have made payments to satisfy claims during the annual reporting period, and “the payments cause the corporation to fail to satisfy the 25 percent test”. Although it is not clear from the face of the Proposed Regulations, the intent here seems to be that under section 1297(f)(3)(A)(i), “applicable insurance liabilities” is defined only to include losses for which the foreign corporation has become liable but which it has not paid under Treas. Reg. § 1.1297-4(f)(2)(i), and therefore the rule for runoff companies will only apply if the payment of claims before year end pushes the amount of applicable insurance liabilities below 25%.

If this is indeed the intent of the language (which, if retained in the final regulations should in any event be clarified), it misunderstands why a runoff company might not meet the 25% test. There is nothing in the Code or in the legislative history that suggests that the alternative facts and circumstances test should apply only if the payment of claims pushes the company below the 25% threshold. A company that pays claims in 2019, 2020 and 2021 is no less a runoff company in 2021 even though claims paid in 2019 pushed the company below the 25% threshold. In addition, this rule misunderstands why a runoff company might fall below the 25% threshold. It is not necessarily because the amount of unpaid claims is decreasing: it is because the company is required to hold capital in a higher ratio to unpaid claims than would normally be required of a company not in runoff. “The risk of adverse reserve development could threaten the capitalization of a run-off company even more than that of a typical property/casualty (re)insurer, given the absence of annual renewal premium to offset cash outflows that may have unexpected size or timing.”\textsuperscript{29}

Accordingly, we recommend that the final regulations remove the requirement that the runoff company have a plan of liquidation, and the requirement that amounts paid by the runoff company cause the corporation to fail to satisfy the 25 percent test. The intent of Congress to permit the application of the alternative facts and circumstances test to runoff companies can be effected by retaining only the second part of the test as stated in Prop. Treas. Reg. § 1.1297-4(d)(3)(ii), as slightly modified:

\begin{quote}
\textsuperscript{28} “[T]he nature of a life/annuity insurer’s liabilities often makes the run-off period significantly longer than for property/casualty and some health insurance business.” Rating Run-Off Insurers, at 2.

\textsuperscript{29} \textit{Id}. 
\end{quote}
a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related circumstances only if the corporation did not issue or enter into any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract, and has no current plan or intention to enter into any insurance, annuity or reinsurance contract other than in the case of a contractually obligated renewal. (emphasis added).

3. Rating-related circumstances

The Proposed Regulations provide that a foreign corporation is considered to fail to satisfy the 25 percent test solely due to rating-related circumstances only if (i) the 25 percent test is not met as a result of the specific requirements with respect to capital and surplus that a generally recognized credit rating agency imposes; and (ii) the foreign corporation complies with the requirements of the credit rating agency in order to maintain the minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year.

The preamble acknowledges that some lines of insurance business require higher levels of capital than others. The preamble then states that the proposed rule is “intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business.” It is not clear how this standard would be applied in practice.

A.M. Best, the leading insurance industry rating agency, evaluates an insurer’s balance sheet strength using a stochastic financial model called Best’s Capital Adequacy Ratio Model (“BCAR”).30 Best’s approach to assessing balance sheet strength is not a static exercise in assigning specific levels of capital to insurers based on their line of business. Rather, the BCAR calculation “depicts the quantitative relationship between a rating unit’s balance sheet strength and key financial risks that could impact such strength.”31 Thus, the amount of capital that Best’s requires will vary not just based on lines of business, but based on other “financial risks”. Best’s breaks down financial risks into three general categories of investment risk, credit risk and underwriting risk, and further subdivides these three risk categories into eight separately analyzed risk components: Fixed Income Securities, Equity Securities, Interest Rate, Credit, Net Loss and Loss Adjustment Expense (“LAE”) Reserves, Net Premiums Written, Business Risk and Potential Catastrophe Losses.32

Furthermore, the analysis of BCAR does not alone decide the assessment of balance sheet strength: Best’s also identifies factors such as liquidity, quality of capital, dependence on

30 Best’s has both a BCAR – P/C model for the property and casualty industry, and a BCAR-Universal that covers both life and P&C.


32 Id. at 4.
reinsurance, quality and appropriateness of reinsurance, asset/liability matching, reserve adequacy, stress tests, internal capital models, and the actions or financial condition of an affiliate or holding company. Thus, Best’s states, “insurers with similar capital positions might be assigned different ratings based on the integration of other key rating factors.”

Finally, tying a company’s status as a PFIC to its level of capital is further complicated by the fact that not all types of capital are created equal. Some types of capital are of higher quality than others. Best’s breaks down Available Capital into four categories: Reported Capital (Surplus) (i.e., surplus as reported on the company’s financial statements), Equity Adjustments, Debt Adjustments, and Other Adjustments. The Equity Adjustments category is subdivided into four components, Unearned Premiums, Assets, Loss Reserves, and Reinsurance. Debt Adjustments is subdivided into Surplus Notes and Debt Service Requirements. Other Adjustments include Future Operating Losses, Intangibles and Goodwill.

In light of the complexity of Best’s determination of adequate capital levels, the test described in the Proposed Regulations may be unworkable in practice, and may have the effect of causing otherwise “plain vanilla” insurance companies to be treated as PFICs.

For example, suppose that a company requires a specific rating in order to, in the words of the Proposed Regulations, “be classified as secure to write new insurance business.” The company could achieve that credit rating by increasing its capital, or by making changes to any number of the factors described above. If the company chooses, for valid business reasons, to increase capital in order to achieve the desired credit rating, and thereby drops below the 25% threshold, it is by no means clear that the reason why the 25 percent test was not met is that the rating agency imposed “specific requirements with respect to capital and surplus”, since the corporation could have achieved the higher rating through other means that would not have required higher levels of capital.

The test for determining whether a higher ratio of capital to liabilities is due to “rating-related circumstances” may be especially problematic when applied to specific types of insurance companies. Treasury and the Service specifically requested comments on certain lines of insurance business, such as financial guaranty insurance, where market realities require a credit rating in excess of the minimum credit rating for a foreign corporation to be classified as secure to write new insurance business in the relevant business line for the current year.

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33 Id. at 1.
34 Id.
35 Id. at 6.
36 It is also not clear why the Proposed Regulations chose to associate “rating-related circumstances” with “capital and surplus”, since the terms “capital” and “surplus” are terms not defined in the Code or regulations, and which mean different things in different contexts. We recommend that, to the extent the test for rating-related circumstances is retained in something like its current form, rating agency requirements should be assessed based on the only corporate attribute that is relevant under section 1297(f)(1)(B), namely “assets”.
We believe, however, that Treasury and the Service are here focusing on the wrong question. The question should not be, is a higher credit rating required for certain lines of business, but rather is a higher level of capital required for that line of business to achieve the same credit rating.

Lines of business which require a higher level of capital as compared to reserves are those which cover risks which are of low frequency but high severity. Examples would be catastrophe risk (e.g., hurricane, earthquake, etc.), as well as financial obligation insurance (or “financial insurance”) which generally includes mortgage insurance, financial guaranty insurance and credit insurance.\footnote{See Property Casualty Insurers Association of America, Financial Obligation Insurance: Systemic Risk Differences, available at http://www.pciaa.net/docs/default-source/default-document-library/Financial_Obligation_Insurance.pdf?sfvrsn=2.}

The latter category (including financial guaranty insurance, for which Treasury and the Service specifically requested comments) is unique because its low-frequency, high-severity character derives from the fact that the risks being insured, unlike natural catastrophe risks, are correlated to the performance of the economy generally.

For example, mortgage insurers are monoline insurance companies that provide insurance against financial loss to mortgage lenders due to nonpayment or default by homeowners.\footnote{A.M. Best, Best’s Methodology and Criteria: Evaluating Mortgage Insurance, at 1 (Feb. 28, 2018) (hereinafter “Evaluating Mortgage Insurance”), available at http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=271055.} As is the case with most insurance companies, Best’s rating analysis of mortgage insurers begins with an evaluation of the company’s balance sheet.\footnote{Id. at 3.} However, mortgage insurance (“MI”) presents unique financial challenges that are likely to lead to a much higher ratio of assets to liabilities:

MI is characterized by its long exposure period, with an average policy period of approximately seven years, and by occasional catastrophic losses due to widespread defaults resulting from sudden, systemic and severe economic downturns. These unique characteristics may lead to losses that far exceed the mortgage insurer’s financial resources, causing financial impairment or insolvency.\footnote{Id.}

Best’s looks at a mortgage insurer’s available capital, but as Best’s notes there are two elements that stand out for mortgage insurers: contingency reserves and unearned premium reserves.\footnote{Id. at 4.}
Mortgage insurers are required by regulators to establish contingency reserves to protect policyholders during extremely adverse economic conditions. These reserves are established as 50% of earned premium and maintained for a period of ten years. Regulatory approval is also required to release these reserves in any year when incurred losses exceed 35% of the corresponding earned premium. Contingency reserves can substantially contribute to Available Capital especially for mortgage insurers that have been in existence for a decade or more.

* * *

Mortgage insurers are required by statute to compute and maintain unearned premium reserves liability based on premium revenue recognition. Apart from recognition of revenue over the policy period and compliance with statutory requirements, unearned premium reserves provide a fund from which refunds can be issued for canceled policies and provide monies for the payment of losses as they arise. Unearned premium reserves associated with non-refundable single premiums can substantially contribute to Available Capital depending on a mortgage insurer’s mix of business origination.

Contingency reserves and unearned premium reserves are two elements of an insurer’s liabilities which the Code expressly excludes from being taken into account. The consequence is that the Proposed Regulations may essentially preclude non-United States mortgage insurers from avoiding PFIC status.

The second element of the “rating-related circumstances” test is that the foreign corporation complies with the requirements of the rating agency in order to maintain the “minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year.” The preamble acknowledges that some lines of insurance business require higher levels of capital than others, but states that the proposed rule is “intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business.”

There are a number of ambiguities in the regulatory language that are not resolved in the preamble and that we recommend be clarified in the final regulations:

- The Proposed Regulations state that the higher level of capital must be required in order to be “classified” as secure to write new business. However, classified by whom? The rating agency? The regulator?

- It is not clear what “secure to write new insurance business” means. It could mean cleared by the regulator to write new insurance business; if that is the intent, the regulations should so state. One possible meaning of this language is that the capital required by the rating agency be sufficient to allow the foreign corporation’s entry into new business to be commercially viable. However, this would be a poor standard for determining minimum levels of capital, since the foreign corporation’s exercise of business judgment in determining the level of
capital it needs to be able to write business should not be second-guessed by the Service.

- The language of the preamble which states that the rule was intended to apply to “the highest minimum credit rating required … for any line of insurance business” could be read as a taxpayer-favorable rule in which the amount of capital which the foreign corporation may treat as attributable to “rating-related circumstances” is the minimum amount of capital that would be required for any line of business, even a highly capital-intensive line of business that the foreign corporation does not intend to enter into. For example, if the foreign corporation is in the auto insurance business, which requires minimum assets of $1 million, but the rating agency tells the corporation that if it were to enter into the catastrophe business it would need to hold $3 million of assets, the foreign corporation would be permitted to treat its holding of $3 million of assets as attributable to rating-related circumstances.

Leaving aside the ambiguities in the Proposed Regulations, there are two aspects of the Proposed Regulations that we propose be changed. The first is that the Proposed Regulations state that minimum credit rating is determined by reference to the company’s ability to write business “for the current year.” It is unclear whether this means that the foreign corporation must reapply the “rating-related circumstances” test ever year. If this is the intent of the Proposed Regulations, we suggest that this is an overly burdensome rule. Once the foreign corporation qualifies for the lower 10% threshold due to rating-related circumstances, we recommend a standard that the test does not need to be reapplied unless there is a change in circumstances. Change in circumstances could be defined to include a change in the lines of business entered into by the company, changes in the market which render existing levels of capital superfluous, or a change in the ratio of liabilities to assets of greater than a fixed percentage.

4. Procedure for allowing a shareholder to elect the alternative facts and circumstances test

As noted above, the election under section 1297(f)(2) to apply the alternative facts and circumstances test is made not by the foreign corporation but by the United States shareholders of the foreign corporation. The Proposed Regulations state that the United States shareholder may make the election if the foreign corporation directly provides the United States person a statement, signed by a responsible officer of the foreign corporation or an authorized representative of the foreign corporation, or the foreign corporation makes a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation that it satisfied the requirements of section 1297(f)(2)).

This system of providing information to the shareholder sufficient to allow it to conclude that the foreign corporation qualifies for the alternative facts and circumstances test is reminiscent of the procedure for allowing a United States shareholder of a PFIC to make a qualified electing fund (“QEF”) election. Anyone who is familiar with the process by which potential PFICs provide an information statement to shareholders in order to make the QEF election knows how difficult it is for PFICs to provide the information statement in a timely manner.
fashion, if the PFIC is able or willing to produce the information statement at all. The difficulty of this process does not bode well for the new proposed process for allowing shareholders to elect the alternative facts and circumstances test, which process would be substantially more complex than the process for providing information to a shareholder sufficient to make a QEF election.

In particular, the Proposed Regulations incorporate a requirement which is not present in the QEF election, which is that the United States person may not rely on any statement to the effect that the corporation qualifies for the alternative facts and circumstances test if the shareholder “knows or has reason to know” that the statement is incorrect.

This standard imposes an excessive burden on shareholders in a foreign corporation. The determination of whether a foreign corporation qualifies for the alternative facts and circumstances test by reason of rating-related circumstances requires not only knowledge of the facts, but application of the law to the facts. Therefore, in order for the shareholder to “know” that the statement is incorrect, the shareholder would have to have both a knowledge of the facts and an understanding of the law.

It may not be too much to ask of a shareholder to have enough knowledge of the factual circumstances of an insurance company to reach a conclusion as to whether the company meets the “rating-related circumstances” test. However, it is too much to ask of the shareholder to reach a judgment, with or without the assistance of counsel, as to whether the foreign corporation meets the test based on an application of the law to the facts. Given that the standard enunciated in the Proposed Regulations for whether a company’s failure to satisfy the 25% test is attributable to runoff-related or rating-related circumstances, and given the fact that on a complex issue different tax advisors will give different answers, it is not appropriate to ask shareholders to reach a legal conclusion. Accordingly, we recommend that the standard which invalidates the election if the shareholder knows or has reason to know that the statement is incorrect be changed to provide that the election will be invalid only if the shareholder knows or has reason to know that the mistaken conclusion of the foreign corporation that it is eligible for the alternative facts and circumstances test is based on erroneous facts.

There are a number of examples in regulations where a taxpayer will not be permitted to rely on a statement of facts if the taxpayer knows or has reason to know that the statement is false. Many of these examples are in the context of ascertaining the obligations of a withholding agent who, unlike the United States shareholder of a foreign insurance company that will be potentially treated as a PFIC, has ready access to facts sufficient to determine the

42 See, e.g., Treas. Reg. § 1.897-2(g)(1)(ii) (a foreign person disposing of an interest in a domestic corporation may rely on documentation that the interest was not a United States real property interest as long as the foreign person did not know or have reason to know that the documentation was incorrect); Treas. Reg. § 1.1441-7(b)(1) (a withholding agent must withhold at the full rate if it knows or has reason to know that that claim of United States status or a reduced rate is unreliable or incorrect); Treas. Reg. § 1.6664-4(b)(1) (taxpayer’s reliance on erroneous information on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith provided the taxpayer did not know or have reason to know that the information was incorrect).
reliability of a statement such as is made on a Form W-8BEN or Form W-9, and in some cases has a professional obligation to ascertain the facts relevant to a recipient of income.

Furthermore, in the rare instance where a regulation requires a withholding agent to reach a conclusion of law, such as whether a recipient of income qualifies for treaty benefits under a limitation on benefits (“LOB”) article of a treaty, the regulation would not permit the withholding agent to rely on a statement from the recipient only if the agent has actual knowledge that the statement is unreliable or incorrect.\textsuperscript{43}

Accordingly, we recommend an approach which allows shareholders to rely on a statement from a foreign corporation as to its PFIC status, except if the shareholder has actual knowledge that the statement is incorrect.

D. Identification of the “applicable financial statement” and the determination of “applicable insurance liabilities.”

1. Limitation on the amount of applicable insurance liabilities

The Proposed Regulations add little to the definitions of “applicable insurance liabilities” and “applicable financial statement” set forth in section 1297(f)(3)(A) and (4)(A). However, there are a number of new rules contained in the Proposed Regulations that are not in the Code and which will make the determination of a company’s applicable insurance liabilities more difficult than the statute may have intended.

Under the Proposed Regulations, the amount of applicable insurance liabilities may not exceed the lesser of (i) the amount of applicable insurance liabilities shown on the most recent applicable financial statement, (ii) the minimum amount of applicable insurance liabilities required by the applicable law or regulation of the jurisdiction of the applicable regulatory body; or (iii) for a foreign corporation that prepares a financial statement on the basis of a financial reporting standard for a purpose other than financial reporting,\textsuperscript{44} the amount of the applicable insurance liabilities on that financial statement.

Clause (i) in the prior paragraph merely restates the rule for determining applicable insurance liabilities under section 1297(f)(1)(B).

Clause (ii) is clearly intended to effect the limitation on the amount of liabilities under section 1297(f)(3)(B)(i), but the introduction of the word “minimum” in the Proposed Regulations adds nothing, while reducing clarity. The Code says that the amount of applicable insurance liabilities is capped at the amount “reported to the applicable insurance regulatory body in the applicable financial statement … (or, if less, the amount required by applicable law or regulation).” The Proposed Regulations do away altogether with the reference to amounts

\textsuperscript{43} See, e.g., Treas. Reg. § 1.1441-6T(b)(1)(i) (withholding agent may rely on beneficial owner’s claim of reliance on a specific LOB provision absent actual knowledge that such claim is unreliable or incorrect).

\textsuperscript{44} Such a financial statement could not be treated as an applicable financial statement because it is not created for financial reporting purposes.
actually reported to the regulator, and simply sets the cap at the “minimum amount of applicable insurance liabilities required by the applicable law or regulation.”

However, the addition of the word “minimum” is at best redundant because the amount “required by applicable law or regulation” already implies the “minimum”. At worst, the use of the word “minimum” could be read to imply that the applicable insurance liabilities should be capped based on a hypothetical “minimum” level of capital that would be required by the regulator for any insurer, even an insurer subject to an entirely different set of circumstances or engaged in a different line of business. The ambiguity created by the unnecessary inclusion of the word minimum is not merely speculative: other instances in the Proposed Regulations where the word “minimum” has been introduced can be read to require that determinations with respect to a specific company be made by reference to “minimum” requirements for other companies under different circumstances.45

Accordingly, we recommend that Treasury and the Service clarify the meaning of the word “minimum” as used in the phrase “minimum amount of applicable insurance liabilities” in Prop. Treas. Reg. § 1.1297-4(e)(2)(ii).

Clause (iii) is presumably included in the Proposed Regulations under the authority of section 1297(f)(3)(B), which permits applicable insurance liabilities to be capped at any amount “as determined under regulations prescribed by the Secretary.”46 Based on the preamble, the intent of this rule appears to be to prevent taxpayers that do not have an applicable financial statement based on GAAP or IFRS from using an applicable financial statement prepared under local accounting rules that “may permit reporting of insurance liabilities in a way that is economically unreasonable and inconsistent with the intent of the QIC rules.”

There are two problems with this rule however. First, although the preamble says that capping the amount of applicable insurance liabilities at the amount that is reported in a GAAP or IFRS statement that is not an applicable financial statement was needed in order to effect the “intent of the QIC rules,” nowhere in the legislative history is there any expression of intent to disregard the amount of applicable insurance liabilities as determined in the annual statement under local accounting rules. In fact, it would appear that an annual statement prepared under local accounting rules should be given preference over a financial statement, even one prepared under GAAP or IFRS, that was not prepared “for financial reporting purposes” and therefore is potentially unreliable.

Second, the Proposed Regulations do not define “financial statement” and provide no rule for determining when a financial statement is prepared “for financial reporting purposes.” Therefore, it will be difficult if not impossible for any foreign corporation to determine whether

45 See discussion above regarding the “minimum credit rating” requirement related to the determination of whether a corporation may apply the alternative facts and circumstances test due to rating-related circumstances.

46 This rule may also be authorized under section 1297(f)(4)(A)(iii), which treats the annual statement required to be filed with the applicable insurance regulatory body as the applicable financial statement “except as otherwise provided by the Secretary in regulations.”
its applicable insurance liabilities as stated in its annual statement under local accounting rules will be overruled by some other document which cannot be identified.

We note also that the Proposed Regulations differ from the Code in that section 1297(f)(3)(B) caps the applicable insurance liabilities at the lesser of the amount reported to the regulator and the amount required by law or regulation. By omitting reference to the amount reported to the regulator, the Proposed Regulations do not take into account a situation where the amount reported to the regulator is lower than the amount required by applicable law or regulation, which might occur as a “permitted practice”.47

Because of the limitation on “applicable insurance liabilities” based on a GAAP or IFRS statement that is not an applicable financial statement is unworkable, we recommend that requirement be removed. Otherwise, we recommend that Treasury and the Service define “financial statement” and “financial reporting purposes.”

2. Restriction on a taxpayer’s ability to change its accounting standard

The Proposed Regulations contain a rule that absent a non-Federal tax business purpose, a foreign corporation must continue to prepare its applicable financial statement under either United States GAAP or IFRS, out of concern that a foreign corporation may change its method for preparing its financial statement to benefit from certain elements of a local regulatory accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of qualifying as a QIC.

As an initial matter, the notion that a taxpayer must establish a business purpose for choosing its accounting standard is a departure from basic principles of taxation. 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. Because of the importance of a corporation’s financial statements to the conduct of its business, we submit that no taxpayer would choose an accounting standard based solely on its tax impact, and therefore the requirement imposed by the Proposed Regulations is inappropriate.

In addition, there is nothing in the Code or the legislative history that suggests that the validity of a financial statement requires a demonstration of a non-tax business purpose for the choice of accounting standard. Quite the contrary: Congress mandated the determination of

47 A “permitted practice” (or a “Permitted Accounting Practice”) is an accounting practice specifically requested by an insurer that departs from National Association of Insurance Commissioners (“NAIC”) SAP and state prescribed accounting practices, and have received approval from the insurer’s domiciliary state regulatory authority.
applicable insurance liabilities on the basis of an applicable financial statement (determined based on the hierarchy in section 1297(f)(4)) whose validity was deemed established because it had been prepared for “financial reporting purposes”, then the validity of the financial statement for purposes of determining applicable insurance liabilities has been definitively established by Congress.

The rule in the Proposed Regulations is also underinclusive, since it only affects companies that have a GAAP or IFRS accounting standard that switch to an accounting standard that provides a better PFIC result. It does not apply to a company that adopts a favorable accounting standard beginning with its first year of operation.

For the reasons discussed above, we recommend that Treasury and the Service remove the rule that a taxpayer may not change its accounting standard unless it can demonstrate a non-Federal tax business purpose.

3. Computation of applicable insurance liabilities

The term “occurred losses” as used in the Proposed Regulations in defining “applicable insurance liabilities” is a departure from common usage both in the Code and in the insurance industry generally. Accordingly, we recommend that Treasury and the Service replace the reference to “occurred losses” with a reference to “losses” or to “incurred losses within the meaning of section 832(b)(5).”

Section 1297(f) provides that “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 or morbidity risks.

The Proposed Regulations define the same term to mean:

(i) Occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts, and health insurance benefits;

(ii) Unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusted unpaid losses described in paragraph (f)(2)(i) of this section; and

(iii) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity
risks, including annuity benefits dependent upon the life expectancy of one or more individuals.

The Proposed Regulations reference to “occurred losses” and the apparent requirement that the adjustment process be fully completed, leaving only the timing of payment, is an inappropriate departure from the language of the Code.

Section 1297(f) references “losses,” not “occurred losses.” More naturally in the Code and in commercial practice, losses means incurred rather than occurred losses. For example, in computing insurance company taxable income, an insurance company reduces its underwriting income by losses incurred and expenses incurred.\(^\text{48}\) Losses incurred means losses incurred during the taxable year, computed in relevant part by including losses paid and all discounted unpaid losses.\(^\text{49}\) There appears to be no basis for narrowing “loss” to include only fully adjusted claims with respect to which liability has been determined.

The section 832 definition of losses aligns with industry practice. The NAIC publishes a glossary of commonly used insurance terms.\(^\text{50}\) There is no definition of an “occurred” loss. There is, however, a definition of an “incurred” loss. Specifically, an incurred loss is defined as:

sustained losses, paid or not, during a specified time period. Incurred losses are typically found by combining losses paid during the period plus unpaid losses sustained during the time period minus outstanding losses at the beginning of the period incurred in the previous period.

Reference to incurred losses more accurately depicts the insurer’s true insurance liabilities, \(e.g.,\) the amount it expects to pay. Limiting the computation to “occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year” would inappropriately limit the amount of losses included in the computation of applicable insurance liabilities.

Accordingly, we recommend that Treasury and the Service replace the reference to “occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year” with a reference to “losses” or to “incurred losses within the meaning of section 832(b)(5).”

\(^{48}\) Section 832(a) and (b).

\(^{49}\) Section 832(b)(5).

\(^{50}\) See https://www.naic.org/consumer_glossary.htm
E. The Section 1297(c) General Look-Through Rule and the Section 1298(b)(7) Domestic Subsidiary Look-Through Rule and Their Application to Qualifying Domestic Insurance Corporations

The Proposed Regulations cause certain minority United States shareholders of foreign holding companies to be treated as indirect owners in PFICs due to the interaction of the section 1297(c) general look-through rule and the section 1298(b)(7) domestic subsidiary look-through rule with the rules relating to qualifying domestic insurance corporations. Because this result is inconsistent with the overall structure of the PFIC rules, and places an undue burden on minority shareholders of a foreign holding company, we recommend that this rule be changed so that minority shareholders will not be treated as shareholders in a PFIC subsidiary of a foreign holding company solely because of the rules relating to qualifying domestic insurance companies.

If 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, that person is considered to own the stock owned directly or indirectly by or for the corporation in proportion to the person’s ownership of the corporation. However, the 50 percent ownership threshold does not apply in the case of stock held through a PFIC, or a corporation that would be a PFIC if it were not a CFC within the meaning of section 957(a).

Thus if the foreign parent of a multinational group (the “tested foreign corporation” or “TFC”) is a PFIC, then under section 1298(a)(2)(B) minority shareholders in the TFC may be deemed to own PFICs that are subsidiaries of the TFC. On the other hand, if the TFC is not a PFIC, under section 1298(a)(2)(A) the minority shareholders would not be treated as owning stock in a PFIC owned by the TFC. It is common in multinational insurance groups for a foreign holding company to own both domestic and foreign insurance company subsidiaries. Therefore, the application of these rules to multinational insurance companies is of prime importance.

The PFIC rules contain two different look-through rules: the section 1297(c) general look-through rule and the section 1298(b)(7) domestic subsidiary look-through rule. Section 1297(c) provides that a TFC is treated as holding its proportionate share of the assets of a look-through subsidiary and receiving its proportionate share of its income. Section 1298(b)(7) provides that certain stock (“qualified stock”) in a domestic C corporation owned by a TFC through a 25-percent-owned domestic corporation is treated as an asset generating non-passive income for purposes of section 1297(a), provided that the TFC is subject to the accumulated earnings tax or waives any treaty protections against the imposition of the accumulated earnings tax.

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51 Section 1298(a)(2)(A).

52 Section 1298(a)(2)(B).

53 The Proposed Regulations provide that the accumulated earnings tax need not actually be imposed on a foreign corporation in a taxable year in order for it to qualify for section 1298(b)(7), and that a TFC must waive any
The Proposed Regulations provide that section 1298(b)(7) should generally take precedence over the section 1297(c) look-through rule when both rules would apply simultaneously because section 1298(b)(7) is the more specific rule where the TFC owns a domestic corporation. Thus, the Proposed Regulations provide that the look-through rule of section 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under section 1298(b)(7), as a non-passive asset producing non-passive income.

However, in the preamble Treasury and the Service expressed concern that some foreign corporations may be relying on section 1298(b)(7) to avoid PFIC status by holding assets through two tiers of domestic subsidiaries. Consequently, the Proposed Regulations provide that if a TFC is not otherwise treated as a PFIC as a result of the application of the domestic subsidiary look-through rule, nevertheless the TFC would be treated as a PFIC solely for purposes of attributing ownership in lower-tier PFICs to the TFC’s minority United States shareholders under section 1298(a). In this situation section 1298(b)(7) is thus turned off.

The Proposed Regulations provide that income of a qualifying domestic insurance corporation is generally not treated as passive income and that assets of a qualifying domestic insurance corporation are not treated as passive assets. A qualifying domestic insurance corporation is defined under Prop. Treas. Reg. § 1.1297-5(d) as a domestic corporation that is subject to tax as an insurance company under subchapter L and is subject to United States federal income tax on its net income. The preamble provides that the qualifying domestic insurance corporation rule is intended to address situations where a TFC owns a domestic insurance corporation through a structure to which section 1298(b)(7) does not apply.

However, for reasons not made clear in the preamble, the rule which treats income and assets of a qualifying domestic insurance corporation as non-passive does not apply for purposes of section 1298(a)(2). Thus, the domestic insurance subsidiaries’ investment income and assets will be treated as passive for this purpose. Where the TFC owns a foreign insurance company which is itself a PFIC, its investment assets and income are also treated as passive assets and income of the TFC under the look-through rules. Therefore, the TFC is a PFIC for purposes of section 1298(a), and minority United States shareholders of the TFC would be treated as owning foreign insurance company subsidiaries that are PFICs even though the TFC would not have been treated as a PFIC had section 1298(b)(7) and the qualifying domestic insurance company rule had not been turned off.

We commend Treasury and Service for providing the general rule that income and assets of a qualifying domestic insurance corporation are not treated as passive. However, we believe that minority United States shareholders in a TFC should not be treated as indirectly owning PFICs if the TFC is not itself a PFIC by applying the look-through rules and taking the general qualifying domestic insurance company rules into account. The Proposed Regulations impose an undue burden on minority shareholders who otherwise do not directly own an interest in a PFIC. Furthermore, they burden foreign companies that own significant investments in domestic benefit under a treaty by attaching to its United States Federal income tax return for the taxable year for which it applies section 1298(b)(7) a statement that it irrevocably waives treaty protection against the imposition of the accumulated earnings tax, effective for all prior, current, and future taxable years.
insurance companies by requiring them to test their ownership in all of their foreign subsidiaries every year to determine if any of them are PFICs.