

Exception from Passive Income for Certain Foreign Insurance Companies (PFIC) CC:PA:LPD:PR (REG 108214-15)

The Global Federation of Insurance Associations (GFIA) is writing to express our concerns on proposed regulations set forth in Internal Revenue Service, Notice of Proposed Rulemaking, 26 CFR Part 1, REG-108214-15, RIN 1545-BM69, entitled “Exception from Passive Income for Certain Foreign Insurance Companies” (the “Proposed Regulations”). GFIA’s 39 member associations represent insurers that account for around 87% of total insurance premiums worldwide. The GFIA is a non-profit association established to represent national and regional insurance associations that serve the general interests of life, health, general insurance and reinsurance companies and to make representations to national governments, international regulators and others on their behalf.

The Notice indicates an intention to address “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.” We understand that the U.S. Government is concerned that some foreign entities may have inappropriately used the insurance company exception in the passive foreign investment company (PFIC) rules to obtain favorable tax treatment, when they are, in reality, offshore investment funds. We believe it is possible to craft regulations that more effectively define insurance companies for purposes of the PFIC requirements so as to address these situations. In order to do so, however, the proposed regulations should be re-proposed to include tests that would create certainty for companies, their shareholders, and the IRS that the companies are indeed exempt from the PFIC rules because they are legitimately insuring risk and are not predominately investment vehicles. The existing Proposed Regulations could mischaracterize virtually all insurance and reinsurance companies as PFICs, and thus substantially impair the opportunities for non-US insurers to raise money using US capital markets. These insurers will be forced to look to capital markets outside the US which will have negative implications for the size, strength and importance of US capital markets.

Summary of Recommendations:

To address our concerns, GFIA recommends the following:

- *The provisions in the active conduct definition restricting recognition of affiliated, shared or contracted employees should be removed from the Proposed Regulations.*
- *The Proposed Regulations should recognize that licensing and regulation as an insurer in a domiciliary jurisdiction is an integral part of a test for an active insurer.*
- *The Proposed Regulations should be amended to include a bright line test based on a reserve to assets ratio.*

- *The test should vary between property/casualty and life insurers due to the significant differences between the business models and risks assumed by these different classes of insurers.*
- *The Proposed Regulations should include a facts and circumstances test to allow testing of insurers that do not qualify under the bright line test.*

1. Active Conduct Definition: Affiliated Employees, Group Structures, Investment Management, Jurisdictional Requirements

With regard to the proposed amendments to the regulations 26 CFR part 1, Section 1.1297-4, (b) (1) and (2). This paragraph defines active conduct and the insurance business as follows:

- (1) Active conduct. The term active conduct has the same meaning as in Sec.1.367(a)-2T(b)(3), *except that officers and employees are not considered to include the officers and employees of related entities* (emphasis added) as provided in Sec. 1.367(a)-2T(b)(3).
- (2) Insurance business. The term insurance business means 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 are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation* (emphasis added)...

Restrictions on qualifying employees

The highlighted portions of the above definitions of “active conduct” and “insurance business” can be read together as establishing a broad requirement that a legal entity cannot be an insurance company if that legal entity does not directly employ the staff necessary to:

- (i) conduct the insurance business, and
- (ii) engage specifically in the investment and administrative activities of the insurance business.

This broad requirement for employing underwriting, investment and administrative staff within the legal entity is not consistent with how insurance business is generally conducted today, and would disqualify a large number of foreign commercial insurers. Treasury’s rules should not penalize foreign insurers for using organizational structures that are also widely used within the US by domestic insurers.

Shared or contracted employee structures exist for a number of reasons such as:

- Employee expenses in legal entities can be reduced by using shared employees who can perform the same investing, claims, technology, ERM (enterprise risk management) analysis, accounting and underwriting functions for various legal entities in the group;
- Employee sharing or contracting is often necessary due to the need to have technical skill sets that are highly sought after in the employment market;
- Groups create “centers of excellence” in certain locations that provide services to all entities in the group and provide training for junior staff.

All these employee and operational functions could not practically be located in each legal entity in the group corporate structure. Shared employees or contracted employees make insurance companies more efficient and improve their performance for the benefit of customers and shareholders.

The insurance regulatory rules in the United Kingdom and the rest of the European Union (EU) prevent a regulated insurance entity from performing functions for another regulated insurance entity, thus such shared employees are located in “related entity” service corporations where they can perform the necessary functions for multiple entities within the group. The “service company” model has been widely exported beyond Europe and is common for US insurance groups.

Recommendation: *the provisions in the active conduct definition restricting recognition of affiliated, shared or contracted employees should be removed from the Proposed Regulations.*

2. Income From Assets Held to Meet Insurance Obligations; Passive vs. Active Income

The Notice also requests comment on “appropriate methodologies for determining the extent to which assets are held to meet obligations under insurance and annuity contracts.” Due to regulatory requirements, we believe that all assets held in an insurance company are there to benefit the policyholders of that company.

Market Conditions and Regulatory Requirements Determine How Much Capital (Assets) an Insurer Holds

Customer contracts, market conditions, regulations and rating agencies all compel insurers to hold capital in excess of the amount necessary to cover known liabilities under insurance and annuity contracts. Jurisdictional regulatory capital requirements are robust and are informed by the standards of the International Association of Insurance Supervisors (IAIS). The IAIS in turn takes its direction from the Financial Stability Board (FSB) and its work is broadly supported by the G20 member states.

But even with more robust solvency capital requirements, domestic and foreign insurers hold capital in excess of regulatory requirements for several reasons such as:

- Insurers compete for business by stressing strong balance sheets.
- For foreign reinsurers doing business with US ceding insurers on a cross-border basis, ratings are embedded in US state insurance regulatory collateral requirements. Per the laws of most states, reinsurers wishing to conduct cross-border trade with US ceding insurers must have credit ratings equivalent to A- or higher in order to achieve meaningful regulatory relief from collateral requirements.

3. Bright line test

We welcome the fact that Treasury is seeking comments on a bright line test to be used to accurately identify the difference between an insurance company and an investment vehicle. A fair and reasonably constructed bright line test would remove long-standing uncertainty with regard to the application of the PFIC rules and it would allow Treasury to accomplish its objective of challenging companies that are attempting to “defer and reduce the tax that otherwise would be due with respect to investment income.”

GFIA proposes defining a bright line test threshold supplemented by a facts and circumstances test which would allow some insurers that are disqualified under the bright line test to qualify after documenting their insurance industry risk bearing activities.

Proposed Reserves to Assets Test

Both property/casualty and life/health insurers have recommended a bright line test based on a reserve to assets ratio. We have not recommended a specific ratio since we are uncertain of what ratio can be fairly applied to the diverse businesses that make up the global insurance community. The test, however, has to be calibrated carefully so as not to exclude many legitimate insurance entities. No one test would accurately define diversified commercial insurers or reinsurers, life/health insurers, annuity providers, property catastrophe specialists, mortgage insurers or financial guaranty insurers. Thus a facts and circumstances test must work in tandem with a bright line test.

The definition of assets would be defined by GAAP and IFRS accounting rules and the data would be found in the insurer's publicly available, audited financial statements. Insurance reserves would be computed based on the year-end financial statements filed with the regulatory authority of the jurisdiction in which the foreign company is organized and regulated.

Recommendation: *the Proposed Regulations should be amended to include a bright line reserves to assets ratio.*

4. Facts and Circumstances Test

A facts and circumstances test needs to operate in a manner that affords a fair review for the shareholder while also providing a timely determination. Insurers can document their active insurer status via public financial statements, regulatory financial statements and other communications with shareholders.

The factors that would be included in the facts and circumstances examination for insurers that failed the bright line test would include but not be limited to:

- The company's insured exposure is reasonable when measured against assets, or capital;
- The company is writing a type of business which is often associated with low reserves but a high degree of risk tied to infrequent events;
- The company is regulated and supervised as an insurer;
- The company manages and holds insured risk;
- The company is a start-up insurer;
- The company is intentionally shrinking its underwriting business (affecting both premiums and liabilities) due to economic conditions in the insurance business;
- The company has an uneven distribution of underwriting premium, liabilities and assets due to merger and acquisition activity, regulatory requirements or other historic business reasons;
- The company's premium income represents a significant portion of its total gross receipts;
- The type of assets held by the company, including an assessment of liquidity needs tied to payment of claims, and investment quality tied to regulatory requirements;
- The company's capital levels are reasonable:
 - a. with regard to rating agency requirements to achieve a minimum rating necessary to participate in a particular market or specific line of business;
 - b. for a particular market, based upon insurers in the same competitive marketplace;

- The company is subject to insurance accounting conventions that require “grossing up” of assets and non-insurance liabilities, which may distort the ratio test;
- The company is in runoff, not generating premium income while managing investments to match the declining liabilities so that it can pay off all policyholder claims.

Recommendation: *the Proposed Regulations should include a facts and circumstances test to allow a review of insurers which fail the bright line test.*

5. **Conclusion**

The US is the world’s largest economy with the world’s largest loss exposures due to:

- the trillions of dollars of property exposed to natural disaster perils
- the unique liability exposures of US businesses and professionals
- having the third largest population in the world it is an enormous market for life, health and annuity products.

Insurance plays a vital role in managing risk for consumers and businesses. The US successfully accomplishes this by spreading risk into the global marketplace. Large potential loss exposures require risk to be held on large balance sheets which benefit from the diversification of risk across perils and across national boundaries. Foreign insurers’ participation through US subsidiaries and through cross-border trade has long made the US insurance market one of the most competitive in the world – something which has provided important benefits to the US economy.

In summary our recommendations would:

- Apply a bright line reserve to assets test to provide a simple, verifiable, reliable means to identify active insurers;
- Apply a facts and circumstances test that allows the IRS to consider other factors; and
- Identify some entities which Treasury would classify as PFIC’s.

We urge the IRS to repropose the regulations in draft form with these key elements. Such a reproposal would provide stakeholders as well as the IRS the appropriate opportunity to develop an exception to the PFIC rules for insurance and reinsurance companies that will most effectively meet the business realities of the marketplace while addressing perceived abuses.

We thank you for the opportunity to comment on the proposed rulemaking.

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About the GFIA

Through its 39 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 59 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.