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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-108214-15

RIN 1545-BM69

Exception from Passive Income for Certain Foreign Insurance Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding when a foreign insurance company's income is excluded from the definition of passive income under section 1297(b)(2)(B). The proposed regulations affect the U.S. shareholders of foreign corporations. This document also invites comments from the public on all aspects of the proposed rules and provides the opportunity for the public to request a public hearing.

DATES: Written or electronic comments and requests for a public hearing must be received by **INSERT DATE 90 DAYS AFTER PUBLICATION IN THE FEDERAL**

REGISTER].

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-108214-15), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-108214-15), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent

electronically via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-108214-15).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Josephine Firehock, (202) 317-4932; concerning submissions of comments or requests for a public hearing, Oluwafunmilayo (Funmi) Taylor at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

The Department of Treasury (Treasury) and the IRS are aware of situations in which a hedge fund establishes a purported foreign reinsurance company in order to defer and reduce the tax that otherwise would be due with respect to investment income. Such foreign corporations may be Passive Foreign Investment Companies (PFICs). For a description of the recent trends and legislative proposals to address the issue, see “Background and Data with Respect to Hedge Fund Reinsurance Arrangements,” JCT (July 31, 2014) (2014 JCT Report); see also Notice 2003-34, 2003-23 IRB 990 (May 9, 2003).

Under section 1297 of the Internal Revenue Code (Code), a foreign corporation is a PFIC if either 75 percent or more of its gross income for the taxable year is passive income (“passive income test”), or on average 50 percent or more of its assets produce passive income or are held for the production of passive income (“passive asset test”). Section 1297(b)(1) generally defines the term “passive income” to mean any income of a kind that would be “foreign personal holding company income” as defined in section 954(c). In general, an asset is characterized as passive if it generates (or is reasonably

expected to generate in the reasonably foreseeable future) passive income as defined in section 1297(b). Assets that generate both passive and non-passive income in a taxable year are treated as partly passive and partly non-passive assets in proportion to the relative amounts of income generated by those assets in that year. See Notice 88-22, 1988-1 CB 489 (February 26, 1988).

For purposes of applying the passive income test, section 1297(b)(2)(B) provides that, except as provided in regulations, the term “passive income” does not include any income that is derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L as an insurance company if the corporation were a domestic corporation. As the terms “active conduct” and “insurance business” are not defined in section 1297, Treasury and the IRS are proposing regulations to clarify the circumstances under which investment income earned by a foreign insurance company is derived in the active conduct of an insurance business for purposes of determining whether the income is passive income, and thus the extent to which the company’s assets are treated as passive assets for purposes of determining whether the company is a PFIC.

The proposed regulations provide that the term “active conduct” has the same meaning as in §1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities. The proposed regulations define the term “insurance business” to mean the business activity of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with investment activities and administrative services that are

required to support or are substantially related to insurance contracts issued or reinsured by the foreign insurance company.¹ The regulations also provide that an investment activity is any activity engaged in to produce income of a kind that would be foreign personal holding company income as defined in section 954(c). The proposed regulations further provide that investment activities will be treated as required to support or as substantially related to insurance or annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts.

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

The proposed regulations also do not define what it means to be “predominantly engaged” in an insurance business. Prior to 1984, the Code did not define an insurance company. Section 1.801-3(a) of the regulations, however, provides in relevant part that an insurance company is a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies.

In 1984, Congress enacted a definition of an “insurance company” that applied only to life insurance companies, and in 2004, a conforming amendment was made to apply the same definition to non-life insurance companies. See sections 816(a) and

¹ Cf. Committee on Ways and Means U.S. House of Representatives, Supplemental Report, The Deficit Reduction Act of 1984, 98th Cong. 2d Sess., H.R. Rept. 98-432, part 2, at 531 (Mar. 5, 1984); Committee on Finance United States Senate, The Deficit Reduction Act of 1984, S. Rept. 98-169, vol. 1, at 1407-08 (April 2, 1984); H.R. Rept. 98-861, 98th Cong. 2d Sess. at 1045 (June 23, 1984) (Conference Report).

831(c). Under this definition, in order for a corporation to be subject to tax as an insurance company under subchapter L, more than half of its business during the taxable year is required to be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. By requiring that more than half of the company's business activity, rather than its predominant business activity, be insurance activity, the current subchapter L statutory rules adopt a stricter and more precise standard than the "primary and predominant" regulatory standard under prior law.² Thus, any company taxable under subchapter L as an insurance company is necessarily predominantly engaged in an insurance business for purposes of section 1297(a)(2)(B).

Proposed Effective/Applicability Date

These regulations are proposed to apply on the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations, and because the regulations do not impose a

² Committee on Ways and Means U.S. House of Representatives, Supplemental Report, The Deficit Reduction Act of 1984, 98th Cong. 2d Sess., H.R. Rept. 98-432, part 2, at 1402-3 (March 5, 1984); Committee on Finance United States Senate, The Deficit Reduction Act of 1984, 98th Cong. 2d Sess., S. Rpt. 98-169, vol. 1, at 525-6 (April 2, 1984); Committee on Ways and Means U.S. House of Representatives, Supplemental Report, The Deficit Reduction Act of 1984, 98th Cong. 2d Sess., H.R. Rept. 98-432, part 2, at 1042-2 (March 5, 1984) (Conference Report); H.R. Rept. 108-457, Pension Funding Equity Act of 2004, 108th Cong. 2d Sess. at 52-53 (April 1, 2004).

collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under “Addresses.” Treasury and the IRS request comments on all aspects of the proposed rules. Comments specifically are requested with regard to how to determine the portion of a foreign insurance company’s assets that are held to meet obligations under insurance contracts issued or reinsured by the company. For example, assets could be considered as held to meet obligations under insurance or annuity contracts issued or reinsured by the corporation to the extent the corporation’s assets in the calendar year do not exceed a specified percentage of the corporation’s total insurance liabilities for the year (for example, the sum of the corporation’s “total reserves” (as defined in section 816(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of section 807(c)). Comments are requested with regard to what percentage would be appropriate. Also, comments are requested with regard to whether other methods would be more appropriate to determine the portion of assets that are held to meet obligations under insurance and annuity contracts.

All comments will be available at www.regulations.gov or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits

comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Josephine Firehock of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Par. 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1297-4 is also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).

Par. 2. Section 1.1297-4 is added to read as follows:

§1.1297-4 Exception from the definition of passive income for certain foreign insurance company income.

(a) Income derived in the active conduct of an insurance business. For purposes of section 1297, the term passive income does not include income earned by a foreign corporation that would be subject to tax under subchapter L if it were a domestic corporation, but only to the extent the income is derived in the active conduct of an insurance business.

(b) Definitions. The following definitions apply for purposes of paragraph (a) of this section--

(1) Active conduct. The term active conduct has the same meaning as in §1.367(a)-2T(b)(3), except that officers and employees are not considered to include the officers and employees of related entities as provided in §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. For purposes of the preceding sentence--

(i) An investment activity is any activity engaged in by the foreign corporation to produce income of a kind that would be foreign personal holding company income as defined in section 954(c); and

(ii) Investment activities are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts.

(c) Effective/applicability date. These regulations apply beginning [EFFECTIVE DATE OF FINAL RULE].

John M. Dalrymple

Deputy Commissioner for Services and Enforcement.

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