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ALERT
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Alternative Investment Tax Matters

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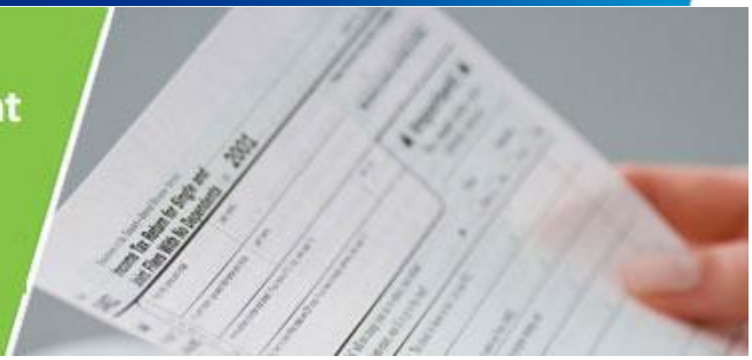

PFIC News Article

For some time, there has been a perceived abuse of the insurance company PFIC exception by hedge funds. Senator Wyden has led the charge to have the IRS and Treasury take action to restrict the PFIC exception to eliminate this perceived abuse. The concern is that hedge funds are making passive investments into offshore reinsurance companies, but the PFIC exception for insurance companies allows hedge funds to treat the investment as an active business. However, insurance and reinsurance companies have large amounts of capital that is invested to support potential claims. The difficulty is coming up with rules that are narrow enough to address hedge fund investment without adversely impacting other insurance companies.

Treasury released proposed regulations on April 23, 2015, which attempt to limit the insurance companies that qualify for the PFIC exception. The primary test remains whether more than half of a company's activities are insurance activities. The proposed regulations would require that insurance activities be performed by only employees and officers of the insurance company itself. Activities of officers and employees of affiliates and activities of independent contractors are specifically excluded. If the proposed regulations are finalized as written, companies that wanted to keep their PFIC status would need to make a major change to their operation. It's almost the norm today that insurance companies do not keep all of their employees and officers in the insurance company. They have shared service arrangements where they use employees of affiliates to provide much of the activities required for their insurance operations. This provision impacts far more than just the "hedge fund captives" that are purportedly the target of the proposed regulations.

The proposed regulations acknowledge that investing is a necessary insurance activity, but specify that investing is only an insurance activity to the extent it involves managing insurance investments. The proposed regulations attempt to distinguish income-generating assets used to support the insurance business from those that generate noninsurance income. However, they do not provide the rules for making this determination. Instead they ask for comments on how this could be done and imply that that insurance assets should be limited to some percentage of the insurance reserves. Any excess assets and income earned on those assets would be considered noninsurance. If those noninsurance assets and income exceed insurance assets and income, it's likely that the company would not be an insurance company and could not avail itself of the PFIC exception.

As you can see, the proposed regulations contain little new guidance. They appear to throw much of the work back to the industry and their consultants to provide comments and suggestions to make these rules workable. We will be providing comments on the proposed regulations and working with Treasury to get to an answer that is sufficiently narrow so that most insurance arrangements will not be negatively impacted.

Contact Information

For additional information regarding this alert, please reach out to Kimberly Sellers.
