
Unintended consequences? The impact of IRS notice 2014-52 on acquisitions of U.S. companies by non U.S. insurers and reinsurers



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* Portions of this article have been adapted from a previous article: William R. Pauls, Inversion Notice Boxes Out Foreign Insurers and Reinsurers, 145 TAX NOTES 1259 (2014). This article is for informational purposes only and is not intended to constitute legal advice. This article does not necessarily represent the views or professional advice of Sutherland Asbill & Brennan LLP.

Abstract

In Notice 2014-52,¹ the U.S. Internal Revenue Service (“IRS”) described several additions that will be made to the Treasury regulations under section 7874² to curb transactions that are commonly called “inversions.” According to Notice 2014-52, one of those additions will target the use of foreign³ “cash boxes” to complete inversions that otherwise fall outside the purview of section 7874 and, in so doing, will equate foreign insurers and reinsurers with cash boxes by offering only a limited exclusion from the cash box analysis for the assets that such companies hold in the ordinary conduct of their insurance and reinsurance businesses. Conversely, Notice 2014-52 offers foreign banks and finance companies much broader exclusions from the cash box analysis for the assets that such companies hold in the ordinary conduct of their banking and financing businesses. Unfortunately, the policy justification underpinning the disparate treatment afforded foreign insurers and reinsurers is not apparent on the face of Notice 2014-52, and, in the absence of further clarification from the U.S. Treasury Department (“Treasury”) and the IRS, that treatment has had, and likely will continue to have, an unwarranted chilling effect on acquisitions of domestic corporations (whether insurance companies or otherwise) by foreign insurers and reinsurers.

¹ 2014-42 I.R.B. 712. The IRS issued Notice 2014-52 on September 22, 2014.

² Unless otherwise specified, all “section” and “§” references are to the U.S. Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury regulations promulgated thereunder, all as in effect (or, in the case of proposed Treasury regulations, as proposed) as of the time that this article was drafted.

This article was drafted prior to the IRS’s issuance of Notice 2015-79, 2015-49 I.R.B. 775, in November 2015, and does not reflect amendments made to the Treasury regulations under section 7874 by T.D. 9761, *Inversions and Related Transactions*, 81 Fed. Reg. 20858 (Apr. 8, 2016)

³ As used in this article with reference to a business entity, the term “domestic” refers to a business entity organized in the U.S. or that otherwise is treated as a domestic entity for U.S. federal tax purposes. See generally § 7701(a)(4) (defining the term “domestic”). The term “foreign” refers to a business entity that is not domestic. See generally § 7701(a)(5) (defining the term “foreign”).

I. Background on Inversions and the General Operation of Section 7874

An inversion typically involves a transaction in which (i) a foreign corporation directly or indirectly acquires the assets held by a domestic corporation and (ii) the shareholders of the domestic corporation exchange some or all of their stock for stock of the foreign corporation.⁴ As relevant to the analysis of the U.S. federal tax consequences associated with an inversion, section 7874 provides the following general rules:

- ▶ If the foreign corporation acquires substantially all of the properties held by the domestic corporation,⁵ and the shareholders of the domestic corporation receive at least 80 percent of the vote or value of the foreign corporation's stock in the acquisition transaction by reason of holding stock in the domestic corporation, the foreign corporation will be treated as a domestic corporation for U.S. federal tax purposes.⁶ This conclusion assumes that, after the acquisition, the "expanded affiliated group" that includes the foreign acquiring corporation does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign acquiring corporation is organized when compared to the total business activities of such expanded affiliated group.⁷
- ▶ Alternatively, if the foreign corporation acquires substantially all of the properties held by the domestic corporation, and the shareholders of the domestic corporation receive at least 60 percent, but less than 80 percent, of the vote or value of the foreign corporation's stock in the acquisition transaction by reason of holding stock in the domestic corporation, then, among other consequences, the use of certain of the domestic corporation's U.S. federal income tax attributes will be limited for a 10-year period.⁸ In this type of inversion,

the foreign acquiring corporation constitutes a "surrogate foreign corporation," and the domestic acquired corporation constitutes an "expatriated entity," under the parlance of section 7874.

For purposes of the foregoing rules, the percentage of the foreign acquiring corporation's stock held by the former shareholders of the domestic acquired corporation after the acquisition is determined under the ownership fraction described in section 7874(a)(2)(B)(ii) (the "Ownership Fraction").⁹ The Ownership Fraction takes into account the shares of the foreign acquiring corporation held by the former shareholders of the domestic acquired corporation in the numerator and the total outstanding shares of the foreign acquiring corporation in the denominator. Thus, in the absence of a rule to the contrary, the Ownership Fraction could be reduced through a contribution of cash or other liquid assets to the foreign acquiring corporation in exchange for new stock in connection with the inversion transaction.

II. The Public Offering Rule of Section 7874(c)(2)(B)

Under the "public offering rule" of section 7874(c)(2)(B), stock sold in a "related" public offering is not taken into account in calculating the Ownership Fraction. In effect, section 7874(c)(2)(B) works to prevent a public offering of stock completed by a foreign acquiring corporation in connection with an inversion from reducing the percentage ownership of the former shareholders of the domestic acquired corporation in the foreign acquiring corporation.

In January 2014, the Treasury and the IRS published temporary regulations that expand the reach of the public offering rule of section 7874(c)(2)(B) to cover private placements and similar transactions involving the stock of a foreign acquiring corporation that participates in an inversion (the "January 2014 Temporary Regulations").¹⁰ In brief, under the January 2014 Temporary Regulations, where a foreign acquiring corporation exchanges its stock for "nonqualified property," i.e., cash and certain other liquid assets,¹¹ that stock generally is treated as

4 Although not a focus of this article, an inversion also can involve a foreign corporation's direct or indirect acquisition of the trade or business assets of a domestic partnership.

5 The foreign corporation's acquisition of the properties held by the domestic corporation can be accomplished directly or indirectly (e.g., via an acquisition of the domestic corporation's stock). See § 7874(a)(2)(B)(i); Treas. Reg. § 1.7874-2(b)(5), (b)(7), (b)(8), (c)(1); see, e.g., Treas. Reg. § 1.7874-2(k)(2), Exs. 1 and 3.

6 See § 7874(a)(2)(B), (b). Correspondingly, the foreign acquiring corporation will become subject to U.S. tax at regular corporate rates, i.e., 35%.

7 See § 7874(a)(2)(B)(iii). The availability of the substantial business activities exception of section 7874(a)(2)(B)(iii) has been limited by temporary Treasury regulations published in June 2012 that were finalized in substantially similar form in June 2015. See Treas. Reg. § 1.7874-3; T.D. 9720, Substantial Business Activities, 80 Fed. Reg. 31837 (June 4, 2015); T.D. 9592, Substantial Business Activities, 77 Fed. Reg. 34785 (June 12, 2012).

8 See § 7874(a)(2)(B); see also § 7874(a)(1), (a)(2)(A), (d)(1), (d)(2), (e)(3). As noted above, this conclusion assumes that the substantial business activities exception of section 7874(a)(2)(B)(iii) is not satisfied.

9 See Treas. Reg. § 1.7874-1(b); Temp. Treas. Reg. § 1.7874-4T(i)(9); Notice 2014-52, supra note 1, at § 2.01(a).

10 See Temp. Treas. Reg. § 1.7874-4T; T.D. 9654, Guidance for Determining Stock Ownership, 79 Fed. Reg. 3094 (Jan. 17, 2014).

11 See Temp. Treas. Reg. § 1.7874-4T(i)(7) (defining the term "nonqualified property").

“disqualified stock” and is excluded from the calculation of the Ownership Fraction.¹² Thus, if a foreign acquiring corporation is capitalized with cash in connection with an inversion, the January 2014 Temporary Regulations generally direct that the stock of the foreign acquiring corporation issued in exchange for that cash be excluded from the Ownership Fraction.¹³

III. The Cash Box Rule of Notice 2014-52

Although the January 2014 Temporary Regulations address situations in which nonqualified property is transferred to a foreign acquiring corporation in exchange for such corporation's stock in a transaction related to the inversion, those regulations do not address the consequences of the foreign acquiring corporation's holding nonqualified property, which was not transferred to such corporation in a transaction related to the inversion. As a result, stock of the foreign acquiring corporation may be included in the denominator of the Ownership Fraction, thereby decreasing that fraction, even though a substantial portion of the value of that stock is attributable to cash or other liquid assets.

As described in Notice 2014-52, the Treasury and the IRS are aware that a domestic corporation may be acquired by a foreign acquiring corporation “that has substantial cash and other liquid assets” in an inversion that is not subject to section 7874.¹⁴ In an effort to limit the availability of this acquisition method, Notice 2014-52 announced that the Treasury and the IRS intend to issue regulations under section 7874(c)(6)¹⁵ providing that a portion of the stock of the foreign acquiring corporation will be **excluded** from the denominator of the Ownership Fraction if more than 50 percent of the gross value of all “foreign group property” constitutes “foreign group nonqualified property” (the “Cash Box Rule”).¹⁶ With respect to the operation of the Cash Box Rule, Notice 2014-52 provides as follows:

- ▶ The 50-percent test will be applied after the inversion and all transactions related to the inversion, if any, are completed.¹⁷
- ▶ Foreign group property means any property held by the “expanded affiliated group” (the “EAG”) after the inversion and all transactions related to the inversion, if any, are completed, other than the following property: (i) Property that is acquired in the inversion and that, at the time of the inversion, was held (directly or indirectly) by the domestic acquired corporation; and (ii) to avoid double counting, stock in a member of the EAG¹⁸ and an obligation of a member of the EAG.¹⁹ For purposes of section 7874 and Notice 2014-52, an EAG includes foreign holding companies, foreign insurance and reinsurance companies, and other foreign corporations, so long as ownership of more than 50 percent of the vote and value in respect of the stock of the relevant corporation (except the common parent of the EAG) is owned by one or more members of the EAG.²⁰ Thus, foreign group property generally includes the assets held by the foreign acquiring corporation and its pre-inversion foreign and domestic subsidiaries that are members of the EAG.
- ▶ Subject to the exclusions discussed in greater detail below, foreign group nonqualified property generally means foreign group property that is described in Temp. Treas. Reg. § 1.7874-4T(i)(7), which includes cash, cash equivalents, and marketable securities.²¹
- ▶ The Treasury regulations implementing the Cash Box Rule will be applicable to inversions completed after September 21, 2014.²²

¹² See Temp. Treas. Reg. § 1.7874-4T(b), (c)(1)(i). But see Temp. Treas. Reg. § 1.7874-4T(c)(2), (d)(1) (providing exceptions to the disqualified stock rules).

¹³ See, e.g., Temp. Treas. Reg. § 1.7874-4T(j), Ex. 1.

¹⁴ See Notice 2014-52, supra note 1, at § 2.01(b).

¹⁵ Under section 7874(c)(6)(B), Treasury has been delegated authority to “prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations . . . to treat stock as not stock.”

¹⁶ See Notice 2014-52, supra note 1, at § 2.01(b).

¹⁷ See id.

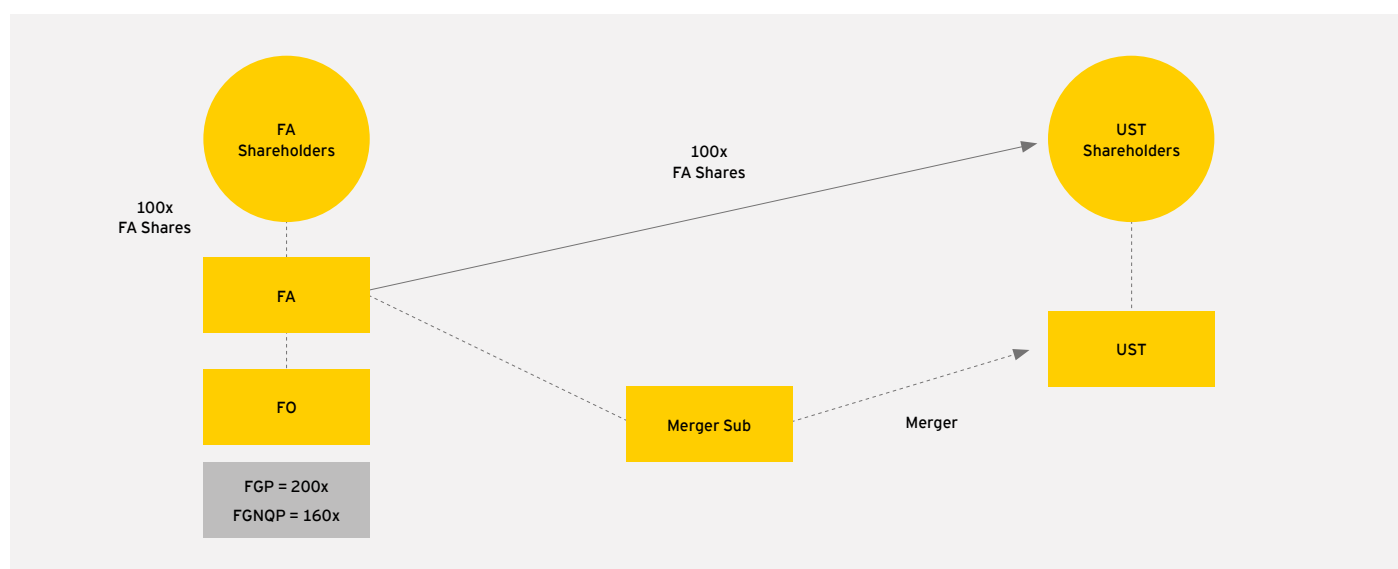
¹⁸ Notice 2014-52 refers to “stock or a partnership interest in a member of the EAG.” Id. Given the composition of an EAG (discussed below), it is unclear what the reference to “a partnership interest” speaks to, other than potentially an equity interest in a business entity organized as a partnership (i) for which a “check-the-box” election has been made under Treas. Reg. § 301.7701-3(c) or (ii) that qualifies as an insurance company subject to per se classification as a corporation under Treas. Reg. § 301.7701-2(b)(4).

¹⁹ See id.

²⁰ Specifically, the term “expanded affiliated group” means an affiliated group as defined in section 1504(a) and as determined as of the end of the day on which the inversion is completed, except that section 1504(a) is applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears and without regard to section 1504(b)(3). See § 7874(c)(1); Temp. Treas. Reg. § 1.7874-4T(i)(3); Notice 2014-52, supra note 1, at § 2.01(a).

²¹ See Notice 2014-52, supra note 1, at § 2.01(b). Notice 2014-52 also provides that foreign group property that otherwise would not be foreign group nonqualified property nevertheless will be treated as foreign group nonqualified property if, in a transaction “related to” the inversion, “substitute” property is acquired in exchange for “transferred” property that would be foreign group nonqualified property had such transferred property not been exchanged for the substitute property. See id. The parameters of this anti-substitution rule are not well defined in the notice.

²² See id. at § 4.



Example 1

Example 1 illustrates the potential application of the Cash Box Rule.

FGP = foreign group property, FGNQP = foreign group nonqualified property, FA = foreign acquirer, FO = single subsidiary of FA, UST = domestic corporation

When triggered, the Cash Box Rule will skew the Ownership Fraction in the direction of the former shareholders of the domestic acquired corporation. In this regard, Notice 2014-52 directs that the portion of the stock of the foreign acquiring corporation that will be excluded from the denominator of the Ownership Fraction will be equal to the product of:

- (i) the value of the stock of the foreign acquiring corporation other than (a) stock described in section 7874(a)(2)(B)(ii) (that is, stock of the foreign acquiring corporation held by the former shareholders of the domestic acquired corporation by reason of their holding stock in the domestic acquired corporation), and (b) stock excluded from the denominator of the Ownership Fraction under either Treas. Reg. § 1.7874-1(b) (because it is held by a member of the EAG) or Temp. Treas. Reg. § 1.7874-4T(b) (because it is disqualified stock); and

- (ii) the “foreign group nonqualified property fraction,” which Notice 2014-52 describes as the gross value of all foreign

group nonqualified property, divided by the gross value of all foreign group property.²³

Facts

- ▶ FA, a country X corporation, is publicly traded and has 100x shares outstanding.
- ▶ FA has a single subsidiary, FO, also a country X corporation.
- ▶ FO has 200x of foreign group property of which 160x is foreign group nonqualified property.
- ▶ FA acquires UST, a domestic corporation, in a reverse subsidiary merger in which the shareholders of UST receive 100x shares of FA stock, so that, after the transaction, FA has 200x shares outstanding.
- ▶ After the acquisition, the FA EAG does not have substantial business activities in country X.

²³ See id. at § 2.01(b). Notice 2014-52 also provides that (i) property received by the foreign acquiring corporation that gives rise to disqualified stock that is excluded from the denominator of the Ownership Fraction pursuant to Temp. Treas. Reg. § 1.7874-4T(b) will be excluded from both the numerator and the denominator of the foreign group nonqualified property fraction, and (ii) a coordination rule similar to Temp. Treas. Reg. § 1.7874-4T(h) (regarding the interaction of the EAG rules with the rule that excludes disqualified stock from the denominator of the Ownership Fraction) will be included in the regulations under development by Treasury and the IRS. See id.

Analysis

- ▶ After the acquisition, 80% (160x / 200x) of the gross value of the FA EAG's assets consists of foreign group nonqualified property.
- ▶ Because the 50% threshold of the Cash Box Rule is satisfied, a portion of the FA stock is excluded from the denominator of the Ownership Fraction. The number of FA shares excluded is equal to the product of:

100x shares (equal to the 200x shares of FA stock outstanding after the transaction minus the 100x "by reason of" FA shares issued to the UST shareholders)
x
80% (equal to the gross value of all of the FA EAG's foreign group nonqualified property (160x) divided by the gross value of all of the FA EAG's foreign group property (200x))
=
80 shares

- ▶ Thus, the Ownership Fraction is equal to:

100x (the number of FA shares received by the UST shareholders)
120x (the 200x FA shares outstanding after the transaction minus the 80x of excluded FA shares)
=
83.3%

- ▶ **Result:** FA is treated as a domestic corporation for U.S. federal tax purposes under section 7874(b).

IV. The Exclusions from Foreign Group Nonqualified Property

Recognizing that many foreign financial institutions, including insurers and reinsurers, are required to hold substantial amounts of property that is described in Temp. Treas. Reg. § 1.7874-4T(i) (7) - generally cash, cash equivalents, and marketable securities ("Liquid Assets") - for regulatory reasons and other bona fide business purposes, Notice 2014-52 excludes from the definition of foreign group nonqualified property certain assets associated

with the ordinary conduct of a banking or financing business and the ordinary conduct of an insurance or reinsurance business. Specifically, Notice 2014-52 excludes from the definition of foreign group nonqualified property "property that gives rise to income described in section 1297(b)(2)(A) or section 954(h) or [section 954](i) (determined by substituting the term 'foreign corporation' for the term 'controlled foreign corporation')." ²⁴

In view of the imprecise language used in Notice 2014-52 to describe these exclusions from foreign group nonqualified property, there remains a fair amount of uncertainty as to the manner in which they will operate in the regulations under development by the Treasury and the IRS. With that point in mind, a discussion of the possible mechanics of each of the exclusions follows below.

A. Property That Gives Rise to Income Described in Section 1297(b)(2)(A)

The first exclusion from foreign group nonqualified property provided in Notice 2014-52 is for property that gives rise to income described in section 1297(b)(2)(A) (the "Section 1297(b)(2)(A) Exclusion"). Section 1297(b)(2)(A) applies for the purposes of determining whether a foreign corporation constitutes a "passive foreign investment company" (a "PFIC") and speaks to the "passive income" aspect of that analysis.²⁵ Specifically, that provision excludes from passive income any income "derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation)."

For purposes of applying section 1297(b)(2)(A), Notice 89-81²⁶ provides that a foreign corporation that is not licensed to do business as a bank in the U.S. may qualify for the passive income exception if it constitutes an "active foreign bank."²⁷ Under Notice 89-81, a foreign corporation qualifies as an active foreign bank for a taxable year if it satisfies a three-prong test:

3. The foreign corporation is licensed in the country in which it conducts its principal banking operations, and those activities are subject to the banking regulators of that country;
4. The foreign corporation conducts an active banking business

²⁴ Id.

²⁵ See § 1297(a), (b)(1).

²⁶ 1989-2 C.B. 399.

²⁷ See Notice 89-81, supra note 26, at § II.

by accepting deposits and making loans regularly; and
5. The foreign corporation derives at least 60 percent of its gross income for the taxable year from bona fide banking activities.²⁸

Notice 89-81 states that it is an “administrative pronouncement” that may be relied on by taxpayers “until regulations are published,” and that any modification of the rules in Notice 89-81 would be prospective.²⁹ Treasury and the IRS published proposed Treasury regulations concerning the application of section 1297(b)(2)(A) (then section 1296(b)(2)(A)) in 1995, but those regulations have yet to be finalized.³⁰ Given the uncertain status of the guidance under section 1297(b)(2)(A), the test provided by Notice 89-81 appears to be the test contemplated to be used for purposes of the Section 1297(b)(2)(A) Exclusion³¹, but that conclusion is subject to confirmation from the Treasury and the IRS.

In view of the preceding discussion, the liquid assets held by a foreign corporation ought to be excluded from foreign group nonqualified property under the Section 1297(b)(2)(A) Exclusion if the following requirements are satisfied:

1. The foreign corporation is licensed and regulated as a bank in its country of principal operation;
2. The foreign corporation is engaged in the active conduct of a banking business;
3. The foreign corporation derives at least 60 percent of its gross income from bona fide banking activities; and
4. The foreign corporation uses the assets in the active conduct of its banking business.³²

²⁸ See *id.* at § II.(A).

²⁹ *Id.* at “Effective Date.”

³⁰ See Prop. Treas. Reg. § 1.1296-4 (1995); Notice of Proposed Rulemaking, Exceptions to Passive Income Characterization for Certain Foreign Banks and Securities Dealers, 60 Fed. Reg. 20922 (Apr. 28, 1995).

³¹ Cf. Chief Couns. Adv. 200134004 (Apr. 18, 2001) (“Although no final regulations have been promulgated, Notice 89-81, 1989-2 C.B. 399, describes the circumstances under which income derived in the banking business by a foreign corporation not licensed to do business as a bank in the United States is treated as active income for purposes of the PFIC passive asset and passive income tests. . . . Based on the cross-reference[] . . . to section 1297 . . . , we conclude that . . . [the] taxpayers were entitled to . . . rely on Notice 89-81 throughout the years here in issue to determine whether, and to what extent, income derived by a foreign corporation not licensed to do business as a bank in the United States but engaged in the banking business should be treated as active income . . .”), available on Westlaw at 2001 WL 961299.

³² Cf. Notice 89-81, *supra* note 26, at §§ II.(B)(2) (“Income earned by an active foreign bank from other activities, such as activities as a dealer in stock and securities, data processing, and management consulting, will not be characterized as nonpassive income pursuant to the exception provided in section 1296(b)(2)(A) of the Code.”), II.(C) (“An asset that generates both income that is treated as nonpassive income under section 1296(b)(2)(A) and income that is passive income under section 1296(b) will be treated as a nonpassive asset and a passive asset in proportion to the amounts of each type of income generated by the asset

B. Property That Gives Rise to Income Described in Section 954(h)

The second exclusion from foreign group nonqualified property offered in Notice 2014-52 is for property that gives rise to income described in section 954(h) (the “Section 954(h) Exclusion”). Section 954(h) provides the active financing exception to the foreign personal holding company income rules of Subpart F (concerning “controlled foreign corporations” (each, a “CFC”)) and excludes from foreign personal holding company income the “qualified banking or financing income” of an “eligible controlled foreign corporation.”³³ Thus, for purposes of the Section 954(h) Exclusion, it seemingly will be necessary to determine whether the relevant property (i) is held by an eligible foreign corporation (determined by substituting the term “foreign corporation” for the term “controlled foreign corporation”) and (ii) gives rise to qualified banking or financing income.

A foreign corporation apparently will constitute an eligible foreign corporation for purposes of the Section 954(h) Exclusion if it (i) is predominantly engaged in the active conduct of a banking, financing, or similar business and (ii) conducts substantial activity with respect to that business.³⁴ In general, a foreign corporation is predominantly engaged in the active conduct of a banking, financing, or similar business if more than 70 percent of its gross income is derived directly from the active and regular conduct of a “lending or financing business” with customers that are not related persons.³⁵ For this purpose, a corporation may engage in a lending or financing business by making loans, purchasing receivables, engaging in leasing, issuing letters of credit or guarantees, or providing charge card or credit card services.³⁶

during the taxable year.”).

³³ As of the time of this article’s drafting, section 954(h) applies to taxable years of foreign corporations beginning before 2015 (and taxable years of U.S. shareholders with or within which any such taxable year of such foreign corporation ends). See § 954(h)(9). The implication of Notice 2014-52 is that the sunset of section 954(h) may not be critical for purposes of determining the operation of this exclusion from foreign group nonqualified property. Alternatively, Notice 2014-52 may portend the extension of that provision.

³⁴ See § 954(h)(2)(A).

³⁵ See § 954(h)(2)(B)(i); see also §§ 954(h)(5)(A) (defining the term “customer”), 954(h)(5)(E) (defining the term “related person”). A foreign corporation also may qualify as an eligible foreign corporation on account of being a licensed bank or a registered broker or dealer. See § 954(h)(2)(B)(ii)-(iii).

³⁶ See § 954(h)(4).

In order for income to constitute qualified banking or financing income for purposes of the Section 954(h) Exclusion, it seemingly will be necessary for that income to be:

- ▶ Derived in the active conduct of a banking, financing, or similar business by the eligible foreign corporation;
- ▶ Derived from one or more transactions (i) with customers located in a country other than the U.S. and (ii) substantially all of the activities in connection with which are conducted, or deemed conducted, directly by the eligible foreign corporation in its home country, i.e., the country under the laws of which the corporation is organized; and
- ▶ Treated as earned in the eligible foreign corporation's home country for purposes of that country's tax laws.³⁷

For purposes of the qualified banking or financing income analysis, two more special rules apply:

- ▶ As noted above, a corporation can qualify as an eligible foreign corporation without being a licensed bank or a registered broker or dealer. However, in such an instance, none of the foreign corporation's income will constitute qualified banking or financing income unless more than 30 percent of its gross income is derived directly from the active and regular conduct of a lending or financing business with customers that are not related persons and that are located within the foreign corporation's home country.³⁸
- ▶ Qualified banking or financing income will not include income derived from transactions with customers located in a country other than the home country of the foreign corporation unless that corporation conducts substantial activity with respect to a banking, financing, or similar business in its home country.³⁹

In view of the preceding discussion, the liquid assets held by a foreign corporation apparently will be excluded from foreign group nonqualified property under the Section 954(h) Exclusion if the following requirements are satisfied:

1. The foreign corporation derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or financing business with unrelated customers;
2. The foreign corporation derives more than 30 percent of its gross income directly from the active and regular conduct of its lending or financing business with unrelated customers that are located within the foreign corporation's home country;
3. The foreign corporation conducts substantial activity with respect to its lending or financing business both generally and in the foreign corporation's home country;
4. The foreign corporation uses the assets in the active conduct of its lending or financing business in the foreign corporation's home country; and
5. The assets give rise to income that is treated as earned in the foreign corporation's home country.

C. Property That Gives Rise to Income Described in Section 954(i)

The last exclusion from foreign group nonqualified property provided in Notice 2014-52 is for property that gives rise to income described in section 954(i) (the "Section 954(i) Exclusion"). Section 954(i) provides the active insurance exception to the foreign personal holding company income rules of Subpart F (as noted above, concerning CFCs) and excludes from foreign personal holding company income the "qualified insurance income" of a "qualifying insurance company."⁴⁰ Thus, for purposes of the Section 954(i) Exclusion, it seemingly will be necessary to determine whether the relevant property (i) is held by a qualifying insurance company (determined by substituting the term "foreign corporation" for the term "controlled foreign corporation") and (ii) gives rise to qualified insurance income.

A foreign corporation apparently will constitute a qualifying insurance company for purposes of the Section 954(i) Exclusion only if it satisfies the following requirements:

- ▶ It is subject to regulation as an insurance (or reinsurance) company by its home country (i.e., the country in which such corporation is created or organized);

³⁷ See § 954(h)(3)(A); see also §§ 954(h)(3)(E) (providing rules applicable to the analysis of whether activities are conducted directly by a foreign corporation in its home country), 954(h)(5)(B) (defining the term "home country"). Although not discussed here, these rules also take into account the income and activities of a "qualified business unit" of the foreign corporation. See § 954(h)(5)(D) (defining the term "qualified business unit" by reference to section 989(a)).

³⁸ See § 954(h)(3)(B); see also § 954(h)(5)(C) (providing that the analysis of where a customer is located "shall be made under rules prescribed by the Secretary").

³⁹ See § 954(h)(3)(C).

⁴⁰ As of the time of this article's drafting, section 954(i) - like section 954(h) - applies to taxable years of foreign corporations beginning before 2015 (and taxable years of U.S. shareholders with or within which any such taxable year of such foreign corporation ends). See § 953(e)(10). The implication of Notice 2014-52 is that the sunset of section 954(i) may not be critical for purposes of determining the operation of this exclusion from foreign group nonqualified property. Alternatively, Notice 2014-52 may portend the extension of that provision.

- ▶ It is authorized by the insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to unrelated persons in that country;
- ▶ It is engaged in the insurance business;
- ▶ It would be subject to tax under Subchapter L of the Code, i.e., the insurance company provisions set forth in sections 801-848, if it were a domestic corporation; and
- ▶ It derives more than 50 percent of its net written premiums from the issuance or reinsurance of contracts covering “applicable home country risks” and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person.⁴¹

Importantly, for purposes of the last requirement, (i) the net written premiums of any “qualifying insurance company branch” of the foreign corporation must be aggregated with those of the corporation,⁴² and (ii) the term “applicable home country risks” generally means risks in connection with property in, liability arising out of activity in, or the lives or health of residents of the home country of the foreign corporation or qualifying insurance company branch, as the case may be, issuing or reinsuring the contract covering the risks.⁴³

In order for income to constitute qualified insurance income for purposes of the Section 954(i) Exclusion, it seemingly will be necessary for that income to be received from an unrelated person and be derived from the investments made by a qualifying insurance company (or its qualifying insurance company branch) of:

- ▶ Its reserves allocable to “exempt contracts” or of 80 percent of its unearned premiums from exempt contracts; or
- ▶ An amount of its assets allocable to exempt contracts equal to one-third of its premiums earned on property, casualty, or

⁴¹ See § 953(e)(3); see also §§ 953(e)(6) (defining the term “home country”), 954(i)(6) (providing that, for purposes of section 954(i), the definitions provided in section 953(e) apply).

⁴² See § 953(e)(3)(B); see also § 953(e)(4) (defining the term “qualifying insurance company branch” to mean a qualified business unit of a foreign corporation if such unit is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons in such home country, and such foreign corporation is a qualifying insurance company, determined under section 953(e)(3) as if such unit were a qualifying insurance company branch). The premiums of a qualifying insurance company branch will be taken into account to the extent that they are treated as earned by such branch in its home country for purposes of that country’s tax laws. See § 953(e)(3)(B) (flush language).

⁴³ See § 953(e)(2)(B)(ii).

health insurance contracts during the taxable year and 10 percent of its reserves for life insurance or annuity contracts.⁴⁴

For purposes of the qualified insurance income analysis, the term “exempt contract” generally means an insurance or annuity contract issued or reinsured by a qualifying insurance company or qualifying insurance company branch in connection with property in, liability arising out of activity in, or the lives or health of residents of a country other than the U.S.⁴⁵ Moreover, two other special limits apply:

1. No contract of a qualifying insurance company or qualifying insurance company branch is an exempt contract unless the company or branch derives more than 30 percent of its net written premiums from exempt contracts (determined without regard to this rule) that cover applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person.⁴⁶
2. A contract issued by a qualifying insurance company or qualifying insurance company branch that covers risks other than applicable home country risks is not an exempt contract unless the company or branch, as the case may be, conducts substantial activity with respect to an insurance business in its home country and performs in its home country substantially all of the activities necessary to give rise to the income generated by such contract.⁴⁷

As such, the liquid assets held by a foreign corporation and its insurance branches apparently will be excluded from foreign group nonqualified property under the Section 954(i) Exclusion only if all of the following requirements are satisfied:

1. The foreign corporation is regulated as an insurance (or reinsurance) company in its home country;
2. The foreign corporation and each of its insurance branches are authorized to sell insurance, reinsurance, or annuity contracts to unrelated persons in their respective home countries;

⁴⁴ See § 954(i)(2); see also §§ 953(e)(5) (providing rules for determining whether a contract issued by a foreign corporation is a life insurance or annuity contract), 954(i)(4)-(5) (providing methods for determining unearned premiums and reserves).

⁴⁵ See § 953(e)(2)(A); see also § 954(i)(6) (providing that, for purposes of section 954(i), the definitions provided in section 953(e) apply).

⁴⁶ See § 953(e)(2)(B); see also § 953(e)(1)(C) (providing that determinations related to exempt contracts are made separately for the qualifying insurance company and its qualifying insurance company branches).

⁴⁷ See § 953(e)(2)(C).

3. The foreign corporation is engaged in an insurance business;
4. The foreign corporation and each of its insurance branches conduct in their respective home countries substantial activity with respect to that business;
5. The foreign corporation and each of its insurance branches perform in their respective home countries substantially all of the activities necessary to give rise to the income generated by a contract issued by such corporation or such branch;
6. The foreign corporation would be subject to tax as an insurance company if it were a domestic corporation, i.e., more than half of the business of the foreign corporation during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies;⁴⁸
7. The foreign corporation and its insurance branches derive more than 50 percent of their aggregate net written premiums from the issuance or reinsurance of contracts covering applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person;
8. The foreign corporation and each of its insurance branches derive more than 30 percent of their net written premiums (as separately determined for each) from the issuance or reinsurance of contracts covering applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person;
9. The assets give rise to income from unrelated persons; and
10. The assets are held as investments by the foreign corporation or the insurance branches in support of their exempt contracts or their required surplus with respect to exempt contracts.

D. Observations on the Exclusions from Foreign Group Nonqualified Property

A review of the exclusions from foreign group nonqualified property included in Notice 2014-52 reveals a rather stark difference in the treatment afforded foreign banks and finance companies versus that afforded foreign insurers and reinsurers. Specifically, the incorporation of the more lenient rules of section 1297(b)(2)(A) and section 954(h) for the former group versus the much more restrictive rule of section 954(i) for the latter group suggests that a strategic decision was made on the part of the Treasury and the IRS to impose stricter limits on the

ability of foreign insurers and reinsurers to acquire domestic corporations. Unfortunately, the policy justification underpinning that decision is not apparent on the face of Notice 2014-52. If, and to the extent that, this decision reflects a concern on the part of the Treasury and the IRS regarding “overcapitalized” insurance companies,⁴⁹ a review of the considerations outlined below reveals that any such concern would be more appropriately addressed outside the scope of section 7874 and the exclusions from foreign group nonqualified property.⁵⁰

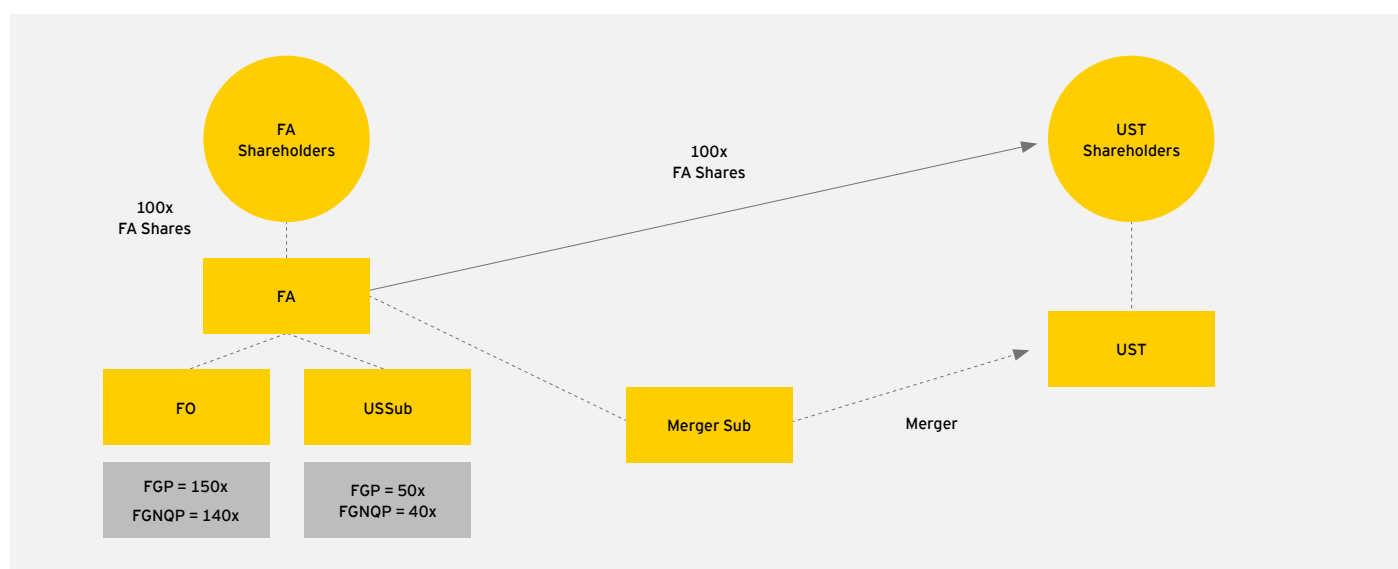
- ▶ Although a significant portion of the assets held by an insurer or a reinsurer in the ordinary conduct of its insurance business may be liquid in character, those assets are not “passive” from the perspective of the company’s business. Rather, those assets are held by such companies in order to ensure that they will have adequate funds on hand to pay claims when losses arise and to meet the requirements and expectations of insurance regulators, ratings agencies, and the insurance market. Thus, those assets simply are not held to facilitate the types of transactions that the Cash Box Rule aims to curb.⁵¹
- ▶ When determining how much capital to hold, insurers and reinsurers generally have to manage competing priorities: the capital demands of insurance regulators, the high cost of capital, and the return demands of investors (returns are maximized if capital is minimized). From a regulatory perspective, the forms of capital across an insurance or reinsurance group are strictly regulated, as regulators look to ensure that obligations to policyholders come first.
- ▶ Acquisitions made by insurers and reinsurers often include equity consideration on account of regulatory, ratings agency, and other business concerns associated with all-cash acquisitions. Thus, while the impact of the Cash Box Rule and, more generally, section 7874 can be mitigated through a foreign corporation’s using only cash consideration to acquire a

⁴⁸ See §§ 816(a), 831(c).

⁴⁹ See, e.g., Notice 2003-34, 2003-1 C.B. 990; cf. Amy S. Elliott & Lee A. Sheppard, *Rolfes Encourages Treaty Policy Rethink To Address Inversions*, 2015 TNT 37-2 (Feb. 25, 2015).

⁵⁰ Notably, there is case law that provides guidance on how to address concerns regarding “overcapitalized” insurance companies. See, e.g., *Serv. Life. Ins. Co. v. United States*, 189 F. Supp. 282, 285-286 (D. Neb. 1960), *aff’d*, 293 F.2d 72 (8th Cir. 1961); see also *Inter-Am. Life Ins. Co. v. Commissioner*, 56 T.C. 497, 507-508 (1971), *aff’d*, 469 F.2d 697 (9th Cir. 1972); *Cardinal Life Ins. Co. v. United States*, 300 F. Supp. 387, 392 (N.D. Tex. 1969), *rev’d on other grounds*, 425 F.2d 1328 (5th Cir. 1970).

⁵¹ See Fact Sheet: *Treasury Actions to Rein in Corporate Tax Inversions* (Sept. 22, 2014) (explaining that the purpose of the Cash Box Rule is to “[l]imit the ability of companies to count passive assets that are not part of the entity’s daily business functions in order to inflate the new foreign parent’s size and therefore evade the 80 percent rule” (emphasis added)), available at <http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx>



Example 2

Example 2 illustrates why this outcome likely has carried the day.

domestic target, that avenue typically is not practical, available, or otherwise permitted for a foreign insurer or reinsurer. Instead, foreign insurers and reinsurers will have to be cognizant of the potential impact of the Cash Box Rule on any acquisition of a domestic corporation - even a much smaller domestic corporation - to the extent equity consideration is used to complete the transaction.

- ▶ It is unlikely that many foreign insurers and reinsurers - especially those that have no prior tax connection with the U.S. - have the infrastructure necessary for purposes of determining whether they can satisfy the many requirements of the Section 954(i) Exclusion. Stated differently, insurers and reinsurers headquartered outside of the U.S. have not tended to incorporate into their business models the need to determine their levels of "home country" risk insured or reinsured, the U.S. tax character of the insurance they have underwritten or reinsured, the U.S. tax equivalent of their insurance reserves, whether their business activities in their respective home countries are sufficiently "substantial," or whether they have satisfied the various other requirements of the Section 954(i) Exclusion.
- ▶ Foreign reinsurers typically reinsure risks arising around the globe, thus making it extremely difficult for those companies

to reach the more-than-50-percent threshold of net written premiums from reinsurance contracts covering risks in their home countries for purposes of the Section 954(i) Exclusion. Thus, even a small amount of equity consideration issued by a foreign reinsurer in an acquisition of a domestic target could cause the foreign reinsurer to become a domestic corporation for U.S. federal tax purposes on account of the workings of the Cash Box Rule and section 7874(b).

In the absence of further clarification from the Treasury and the IRS, the disparate treatment afforded foreign insurers and reinsurers in Notice 2014-52 has had, and likely will continue to have, an unwarranted chilling effect on business combinations involving foreign insurers and reinsurers and domestic corporations (whether insurance companies or otherwise).⁵²

⁵² See Alison Bennett & Laura Davison, Caught in Crosshairs: Insurers Waiting for Inversion Guidance Fear M&A Slowdown, 80 DTR GG-1 (Apr. 27, 2015); see also Sonali Basak, Tax-Dodge Scrutiny in U.S. Repels Bidders from Bermuda Takeovers, 97 DTR G-1 (May 20, 2015); cf. Adam Cancryn & Muhammad Umer Shahid, Insurance M&A Scoreboard, Q3'14, SNL Financial (Oct. 28, 2014) ("When an insurer does do a headline-grabbing deal, it wants to be absolutely sure every one of those headlines will be positive. . . . At least for now, shareholders and regulators are watching too closely for companies to roll the dice on risky acquisitions."), available at <https://www.snl.com/interactivex/article.aspx?id=29604736&KPLT=6>

Facts

- ▶ The facts are the same as those in Example 1, with the exceptions noted below.
- ▶ FA has two subsidiaries:
 - FO, a country X reinsurance company that reinsures risk located outside of country X; and
 - USSub, a domestic non-life insurance company that insures risks located in the U.S.
- ▶ FO has 150x of total assets (and thus foreign group property), 140x of which FO holds in the form of cash or marketable securities as reserves for use in its reinsurance business, but which do not give rise to income described in section 954(i) because the reinsured risks are located outside of country X.
- ▶ USSub has 50x of total assets (and thus foreign group property), 40x of which USSub holds in the form of cash or marketable securities as reserves for use in its insurance business, but which do not give rise to income described in section 954(i) because USSub is a domestic corporation and the insured risks are located in the U.S.

Analysis

- ▶ After the acquisition, 90% (180x / 200x) of the gross value of the FA EAG's assets consist of foreign group nonqualified property, because none of the cash or marketable securities held by FO and USSub qualify for the Section 954(i) Exclusion, even though all of those assets are used in the active conduct of the FA EAG's insurance business.
- ▶ Because the 50% threshold of the Cash Box Rule is satisfied, 90x shares of FA stock are excluded from the denominator of the Ownership Fraction, with the result that the Ownership Fraction is:

100x (the number of FA shares received by the UST shareholders)
120x (the 200x FA shares outstanding after the transaction <i>minus</i> the 90x of excluded FA shares)
=
90.9%

- ▶ **Result:** FA is treated as a domestic corporation for U.S. federal tax purposes under section 7874(b).

V. Recommendations for Future Guidance Under the Cash Box Rule

Considering all of the issues discussed above, it is apparent that the Cash Box Rule is too broad in its approach with respect to foreign insurers and reinsurers. One potential solution to this problem would be the addition of an exclusion from foreign group nonqualified property for property that gives rise to income described in section 1297(b)(2)(B).⁵³

Similar to section 1297(b)(2)(A), section 1297(b)(2)(B) excludes from passive income any income "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 if it were a domestic corporation." Although the scope of section 1297(b)(2)(B), like that of section 1297(b)(2)(A), continues to be refined, an exclusion incorporating section 1297(b)(2)(B) would focus on the status of the foreign corporation as an insurance company for U.S. federal tax purposes engaged in the active conduct of an insurance business. Such an exclusion from foreign group nonqualified property would offer a far more practical alternative than the Section 954(i) Exclusion and would be on par with the Section 1297(b)(2)(A) Exclusion. Moreover, as more guidance is developed under section 1297(b)(2)(B), one would expect that such guidance would have a corresponding impact on the scope of property excluded from foreign group nonqualified property.

With respect to the last point of the preceding paragraph, the Treasury and the IRS published proposed Treasury regulations under section 1297(b)(2)(B) on April 24, 2015 (the "Section 1297(b)(2)(B) Proposed Regulations"). The release of the Section 1297(b)(2)(B) Proposed Regulations⁵⁴ did not come as a surprise given the recent media attention that has been focused on the application of section 1297(b)(2)(B) to foreign insurers and reinsurers,⁵⁵ and, as expected, the proposed regulations offer

⁵³ See William R. Pauls, *Inversion Notice Boxes Out Foreign Insurers and Reinsurers*, 145 TAX NOTES 1259, 1266 (2014); see also Alison Bennett, *Inversions Notice Should Expand Exception on "Cash Boxes" for Insurers*, Critics Tell IRS, 244 DTR G-5 (Dec. 18, 2014); Andrew Velarde, *Treasury May Consider PFIC Insurance Exception in Inversion Regs*, 2014 TNT 219-3 (Nov. 13, 2014).

⁵⁴ See Prop. Treas. Reg. § 1.1297-4 (2015); Notice of Proposed Rulemaking, *Exception from Passive Income for Certain Foreign Insurance Companies*, 80 Fed. Reg. 22954 (Apr. 24, 2015).

⁵⁵ See, e.g., Luca Gattioni-Celli & William R. Davis, *Koskinen Open to Wyden's 90-Day Reinsurance Guidance Deadline*, 2015 TNT 23-1 (Feb. 4, 2015); Eric Kroh, *IRS Promises Rules on Hedge Fund Reinsurance Strategy*, Law360 (Feb. 3, 2015), available at <http://www.law360.com>; Lindsey McPherson, *Wyden Pans Treasury Response to Reinsurance Tax Schemes*, 2014 TNT 177-2 (Sept. 12, 2014); Zachary R. Mider, *Treasury Weighing Action on Hedge Fund Tax 'Loophole'*, 177 DTR G-10 (Sept. 12, 2014).

a few points that demand further consideration, particularly with respect to the “active conduct” and “insurance business” aspects of the exception. Although a complete analysis of the Section 1297(b)(2)(B) Proposed Regulations is beyond the scope of this article, it will suffice to say that the initial reactions to those proposed regulations have been roundly negative.⁵⁶ Those reactions reflect the fact that the Section 1297(b)(2)(B) Proposed Regulations do not cite, and otherwise are not grounded in, the legislative history of section 1297(b)(2)(B),⁵⁷ which foreign insurers and reinsurers have had to rely on for nearly 30 years for purposes of determining whether they satisfy the exception offered under section 1297(b)(2)(B).⁵⁸

One final point of consideration concerns the fact that the exclusions from foreign group nonqualified property only apply to the liquid assets held by the foreign acquiring corporation and its pre-inversion foreign subsidiaries that are members of

the EAG.⁵⁹ Foreign-controlled groups often include domestic subsidiaries, and it seems inconsistent with the policy goals of the Cash Box Rule to preclude the property of those domestic subsidiaries from potentially being eligible for the exclusions from foreign group nonqualified property. To the extent that this result was intended by the Treasury and the IRS in Notice 2014-52, it should be explicated in the Treasury regulations implementing the Cash Box Rule. Otherwise, those Treasury regulations should clarify that the exclusions from foreign group nonqualified property potentially apply to the property held by the foreign acquiring corporation and its pre-inversion foreign and domestic subsidiaries that are members of the EAG.

VI. Parting Thoughts

The elephant in the room with respect to the Cash Box Rule (and, for that matter, the Section 1297(b)(2)(B) Proposed Regulations) is the inability of the Treasury and the IRS to define what they believe constitutes a “hedge fund reinsurer,” which, by many press accounts, apparently is the most evil thing imaginable. Lost in the drama and rhetoric of all this puffery is the reality that the vast majority of foreign insurers and reinsurers do not come close to falling within the small category of companies described by the IRS in Notice 2003-34,⁶⁰ i.e., the authority upon which the “hedge fund reinsurer” notion appears to be based.⁶¹ In this regard, Notice 2003-34 provides as follows:

- ▶ The typical arrangement involves a Stakeholder, subject to U.S. income taxation, investing (directly or indirectly) in the equity of an enterprise (“FC”), usually a corporation organized outside the United States. FC is organized as an insurance company and complies with the applicable local laws regulating insurance companies.
- ▶ FC issues “insurance or annuity contracts” or contracts to “reinsure” risks underwritten by insurance companies. Some of the contracts do not cover insurance risks. Other contracts significantly limit the risks assumed by FC through the use of retrospective rating arrangements, unrealistically low policy

⁵⁶ See, e.g., Eric Kroh, IRS May Need Legislative Fix for Reinsurance Tax Strategy, Law360 (Apr. 27, 2015), available at <http://www.law360.com>; Nathan J. Richman, Government Meets Wyden's Deadline for Releasing Reinsurance Regs, 2015 TNT 79-1 (Apr. 24, 2015); see also Andrew Velarde, Practitioners Urged To Submit Detailed Insurance Regs Comments, 2015 TNT 104-4 (June 1, 2015); Eric Kroh, Tax Pros Warn New IRS Rule on Reinsurance May Backfire, Law360 (February 6, 2015), available at <http://www.law360.com>.

⁵⁷ Section 1297(b)(2)(B) (then section 1296(b)(2)(B)) was enacted in 1986 as part of the Tax Reform Act of 1986 (TRA 1986), Pub. L. No. 99-514, and subsequently was amended in 1988 by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), Pub. L. No. 100-647. The Conference Report for TRA 1986 provides that an “exception to the definition of passive income is provided for income derived by bona fide banks and insurance companies, subject to regulatory exceptions. . . . A bona fide insurance company is any foreign insurance company that would be subject to taxation under subchapter L if the company were a domestic insurance company.” H.R. REP. NO. 99-841, at II-644 (1986) (Conf. Rep.) (emphasis added). TAMRA added the “predominantly engaged in an insurance business” requirement to section 1297(b)(2)(B) (then section 1296(b)(2)(B)). Both the House and Senate Reports accompanying TAMRA describe the addition of this language as “clarifying” the exception from passive income “for income received by bona fide insurance companies.” H.R. REP. NO. 100-795, at 273 (1988) (emphasis added); see also S. REP. NO. 100-445, at 286 (1988). The House and Senate Reports further provide that: This exception from passive income extends only to income derived by insurance companies that are predominantly engaged in the active conduct of an insurance business and that would be taxed under the special rules applicable to domestic insurance companies if they were domestic corporations. Thus, income derived by entities engaged in the business of providing insurance will be passive income to the extent the entities maintain financial reserves in excess of the reasonable needs of their insurance business. H.R. REP. NO. 100-795, at 273 (1988); see also S. REP. NO. 100-445, at 286 (1988). Thus, as directed by this legislative history, section 1297(b)(2)(B) provides an exception for income received by a “bona fide insurance company” with “reasonable” financial reserves.

⁵⁸ As a general matter, proposed Treasury regulations do not carry the weight of temporary or final Treasury regulations, although, in certain instances, proposed Treasury regulations may “constitute a body of informed judgment on which courts [and, correspondingly, taxpayers] may draw for guidance.” *Stokely USA, Inc. v. Commissioner*, 100 T.C. 439, 455 (1993). Specifically, proposed Treasury regulations “can be useful as guidelines where they closely follow the legislative history of the [underlying] act.” *Van Wyk v. Commissioner*, 113 T.C. 440, 444 (1999). As noted above, the Section 1297(b)(2)(B) Proposed Regulations do not seem to fall under this category of guidance.

⁵⁹ See William R. Pauls, Inversion Notice Boxes Out Foreign Insurers and Reinsurers, supra note 53, at 1262, 1263, 1265, and 1266. By their terms, each of sections 954(h), 954(i), 1297(b)(2)(A), and 1297(b)(2)(B) only apply to foreign corporations.

⁶⁰ Supra note 49.

⁶¹ Although this reality has been conveniently dismissed by those beating the drum of discontent, it nevertheless is borne out in a recent analysis performed by the Joint Committee on Taxation. See Staff of the Joint Committee on Taxation, Background and Data with Respect to Hedge Fund Reinsurance Arrangements, at 12-15 (July 30, 2014), available at <https://www.jct.gov/publications.html?func=startdown&id=4745>

limits, finite risk transactions, or other similar devices.

- ▶ FC's actual insurance activities, if any, are relatively small compared to its investment activities. FC invests its capital and the amounts it receives as consideration for its "insurance" contracts in, among other things, hedge funds or investments in which hedge funds typically invest. As a result, FC's portfolio generates investment returns that substantially exceed the needs of FC's "insurance" business. FC generally does not currently distribute these earnings to Stakeholder.
- ▶ Stakeholder takes the position that FC is an insurance company engaged in the active conduct of an insurance business and is not a passive foreign investment company. Therefore, when Stakeholder disposes of its interest in FC, it will recognize gain as a capital gain, rather than as ordinary income.⁶²

Whether the Treasury and the IRS will heed the recommendations offered here and by other commentators is unknown.

Nevertheless, now is the time to be forthright about the effects of these new rules on foreign insurers and reinsurers, unless those companies wish to become subject to a new U.S. tax paradigm.

⁶² Notice 2003-34, *supra* note 49, at § II.

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