Inversion Notice Boxes Out
Foreign Insurers and Reinsurers

by William R. Pauls

Reprinted from Tax Notes, December 15, 2014, p. 1259
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In this article, Pauls discusses the disparate treatment given to foreign insurers and reinsurers in the latest inversion notice and the chilling effect that treatment could have on acquisitions of domestic corporations by those companies. He also offers several recommendations for addressing this disparity in the regulations under development by Treasury and the IRS.

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In Notice 2014-52, 2014-42 IRB 712 (the Inversion Notice),1 the IRS described additions that will be made to the Treasury regulations under section 7874 to curb inversions. As discussed in this article, the Inversion Notice targets the use of foreign “cash boxes” to complete inversions that otherwise would fall outside the purview of section 7874. In so doing, the Inversion Notice equates foreign insurers and reinsurers with cash boxes by offering only a limited exclusion for the assets that those companies hold in the ordinary conduct of their insurance businesses. Conversely, the Inversion Notice offers foreign banks and finance companies much broader exclusions for the assets that those 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 the Inversion Notice, and, in the absence of further clarification from Treasury and the IRS, that treatment could have a chilling effect on acquisitions of domestic corporations (whether insurance companies or otherwise) by foreign insurers and reinsurers, just when their interest in completing those acquisitions is picking up.

A. The General Operation of Section 7874
An inversion typically involves a transaction in which a foreign corporation acquires the assets held by a domestic corporation and the shareholders of the domestic corporation exchange some or all of their stock for stock of the foreign corporation.2 As relevant to the determination 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,3 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 inversion, the foreign corporation will be treated as a domestic corporation for U.S. federal tax purposes.4 This conclusion assumes that, after the inversion, 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.5

• If the foreign corporation acquires substantially all of the properties held by the domestic

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1The IRS issued the Inversion Notice on September 22, 2014.

2Although not a focus of this article, an inversion also can involve a foreign corporation’s acquisition of the trade or business assets of a domestic partnership. As used in this article with reference to a business entity, the term “domestic” refers to a business entity organized in the United States or that otherwise is treated as a domestic entity for U.S. federal tax purposes. See generally section 7701(a)(4) (defining the term “domestic”). Conversely, the term “foreign” refers to a business entity that is not domestic. See generally section 7701(a)(5) (defining the term “foreign”).

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

4See section 7874(a)(2)(B), (b).

5See section 7874(a)(2)(B)(iii). The availability of this substantial business activities exception was limited by temporary regulations published in June 2012. See reg. section 1.7874-3T, T.D. 9592.
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 inversion, then, among other consequences, the use of certain of the domestic corporation’s tax attributes will be limited for a 10-year period. 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 inversion is determined under the ownership fraction described in section 7874(a)(2)(B)(ii) (the ownership fraction). 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.

B. The Public Offering Rule

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, 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). In brief, under the January 2014 temporary regulations, where a foreign acquiring corporation exchanges its stock for nonqualified property, that is, cash and certain other liquid assets, that stock generally is treated as disqualified stock and is excluded from the calculation of the ownership fraction. 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.

C. The Cash Box Rule of the Inversion Notice

Although the January 2014 temporary regulations address situations in which nonqualified property is transferred to a foreign acquiring corporation in exchange for the corporation’s stock in a transaction related to the inversion, those regulations do not speak to the consequences of the foreign acquiring corporation’s holding nonqualified property that was not transferred to the 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 the Inversion Notice, 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. In an effort to limit the availability of this acquisition method, the Inversion Notice announced that Treasury and the IRS intend to issue regulations under section 7874(c)(6) 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). Therefore, if the cash box rule is triggered, it will skew the ownership fraction in the direction of the former shareholders of the domestic

See section 7874(a)(2)(B); see also section 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.

See reg. section 1.7874-1(b); reg. section 1.7874-4T(i)(9); Inversion Notice, section 2.01(a).

See reg. section 1.7874-4T; T.D. 9654.
acquired corporation. Regarding the operation of the cash box rule, the Inversion Notice provides as follows:

- The 50 percent test will be applied after the inversion and all transactions related to the inversion, if any, are completed. 15
- 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 EAG 16 and an obligation of a member of the EAG and an obligation of a member of the EAG. 17 For purposes of section 7874 and the Inversion Notice, an EAG includes foreign holding companies, foreign insurance and reinsurance companies, and other foreign corporations, as 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. 18 Thus, foreign group property 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 (the FGNP exclusions) generally means foreign group property that is described in reg. section 1.7874-4T(i)(7), which includes cash, cash equivalents, and marketable securities. 19

- The Treasury regulations implementing the cash box rule will be applicable to inversions completed after September 21, 2014. 20

If the cash box rule applies, the Inversion Notice states that the portion of the stock of the foreign acquiring corporation that will be excluded from the denominator of the ownership fraction essentially will be equal to the product of (i) the value of the stock of the foreign acquiring corporation held by its pre-inversion shareholders and (ii) the “foreign group nonqualified property fraction,” which the Inversion Notice describes as the gross value of all foreign group nonqualified property, divided by the gross value of all foreign group property. 21

D. The FGNP Exclusions

Recognizing that many foreign financial institutions, insurers, and reinsurers are required to hold substantial amounts of property that is described in reg. section 1.7874-4T(i)(7) (passive assets) for regulatory reasons and other bona fide business purposes, the Inversion Notice 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 business. Specifically, the Inversion Notice 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 (i) (determined by substituting the term ‘foreign corporation’ for the term ‘controlled foreign corporation’).” 22

Because of the imprecise language used in the Inversion Notice to describe the FGNP exclusions, there remains a fair amount of uncertainty regarding the manner in which they ultimately will operate in the regulations under development by Treasury and the IRS. With that point in mind, a discussion of the possible mechanics of each of the FGNP exclusions follows below.

Footnote continued in next column.

15Id. 16The Inversion Notice 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 reg. section 301.7701-3(c) or (ii) that qualifies as an insurance company subject to per se classification as a corporation under reg. section 301.7701-2(b)(4).
17Id. 18Specifically, 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 section 7874(c)(1); reg. section 1.7874-4T(i)(3); Inversion Notice, section 2.01(a); see also reg. section 1.7874-3T(d)(4).
19See Inversion Notice, section 2.01(b). The Inversion Notice 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. Id. The parameters of this anti-substitution rule are not well defined in the Inversion Notice.
20Id. at section 4. 21Id. at section 2.01(b). The Inversion Notice 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 under reg. section 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 reg. section 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. Id.
22Id.
1. Property that gives rise to income described in section 1297(b)(2)(A). The first exclusion from foreign group nonqualified property provided in the Inversion Notice 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 purposes of determining whether a foreign corporation constitutes a “passive foreign investment company” and speaks to the “passive income” aspect of that determination. 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 89-81, 1989-2 C.B. 399, provides that a foreign corporation that is not licensed to do business as a bank in the United States may qualify for the passive income exception if it constitutes an “active foreign bank.” Under Notice 89-81, a foreign corporation qualifies as an active foreign bank for a tax year if it satisfies a three-prong test:
• 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;
• the foreign corporation conducts an active banking business by accepting deposits and making loans regularly; and
• the foreign corporation derives at least 60 percent of its gross income for the tax year from bona fide banking activities.

Notice 89-81 states that it is an “administrative pronouncement” that may be relied upon by taxpayers “until regulations are published,” and that any modification of the rules in Notice 89-81 would be prospective. Treasury and the IRS published proposed 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. Given the uncertain status of the guidance 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.”

In view of the preceding discussion, the Inversion Notice seems to contemplate that, under the section 1297(b)(2)(A) exclusion, foreign group nonqualified property will not include the passive assets held by a foreign corporation that (i) is licensed and regulated as a bank in its country of principal operation, (ii) is engaged in the active conduct of a banking business, and (iii) derives at least 60 percent of its gross income from bona fide banking activities, but only to the extent that those assets are used in the active conduct of that banking business. Thus, if those requirements are satisfied by the foreign acquiring corporation or any of its pre-inversion foreign subsidiaries that are members of the EAG, one probably should not expect the passive assets held by such corporation to be treated as foreign group nonqualified property for purposes of the cash box rule.

2. Property that gives rise to income described in section 954(h). The second exclusion from foreign group nonqualified property offered in the Inversion Notice 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. Specifically, section 954(h)(1) excludes from foreign personal 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.”

See section 1297(a), (b)(1).
24See Notice 89-81, at section II.
25Id. at section II.A.
26Id. at “Effective Date.”
28Cf. ILM 200134004 (“Although no final regulations have been promulgated, Notice 89-81, 1989-2 C.B. 399, describes the (Footnote continued in next column.)
holding company income the “qualified banking or financing income” of an “eligible controlled foreign corporation.”

For a foreign corporation to constitute an eligible foreign corporation (determined for purposes of this exclusion by substituting the term “foreign corporation” for the term “controlled foreign corporation”), the corporation must be predominantly engaged in the active conduct of a banking, financing, or similar business and conduct substantial activity with respect to that business. 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. 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 or credit card services.

Furthermore, for income to constitute qualified banking or financing income, the income generally must:

- be derived in the active conduct of a banking, financing, or similar business by the eligible foreign corporation;
- be derived from one or more transactions (i) with customers located in a country other than the United States 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; that is, the country under the laws of which the corporation is organized; and
- be treated as earned in the eligible foreign corporation’s home country for purposes of that country’s tax laws.

Finally, for purposes of the qualified banking or financing income determination, two 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 corporation’s income will constitute qualified banking or financing income unless more than 30 percent of the corporation’s 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 such corporation’s home country.
- 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.

Taking into account the various requirements of section 954(h), the Inversion Notice seems to contemplate that, under the section 954(h) exclusion, foreign group nonqualified property will not include the passive assets held by a foreign corporation that (i) 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; (ii) derives more than 30 percent of its gross income directly from the active and regular conduct of the lending or financing business with unrelated customers that are located within the corporation’s home country; and (iii) conducts substantial activity with respect to that business both generally and in the corporation’s home country, but only to the extent that the assets are used in the active conduct of the lending or financing business in the foreign corporation’s home country and give rise to income treated as earned in the foreign corporation’s home country for purposes of that country’s tax laws. Thus, if these requirements are satisfied by the foreign acquiring corporation or any of its pre-inversion foreign subsidiaries that are members of the EAG, one probably should not expect the passive assets held by that corporation to be treated as foreign group nonqualified property for purposes of the cash box rule.

3. Property that gives rise to income described in section 954(i). The last exclusion from foreign

31 See section 954(h)(2)(A).
32 See section 954(h)(2)(B)(i); see also section 954(h)(5)(A) (defining the term “customer”), and section 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 section 954(h)(2)(B)(ii)(iii).
33 See section 954(h)(4).
34 See section 954(h)(3)(A); see also section 954(h)(3)(E) (providing rules applicable to the determination of whether activities are conducted directly by a foreign corporation in its home country), and section 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 section 954(h)(5)(D) (defining the term “qualified business unit”).
35 See section 954(h)(3)(B); see also section 954(h)(5)(C) (providing that the determination of where a customer is located “shall be made under rules prescribed by the Secretary”).
36 See section 954(h)(3)(C).
group nonqualified property provided in the Inversion Notice 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. Similar to section 954(h)(1), section 954(i)(1) excludes from foreign personal holding company income the “qualified insurance income” of a “qualifying insurance company.”

A foreign corporation constitutes a qualifying insurance company (determined for purposes of this exclusion by substituting the term “foreign corporation” for the term “controlled foreign corporation”) if it:

- is subject to regulation as an insurance (or reinsurance) company by its home country, that is, the country under the laws of which the corporation is organized;
- is authorized by the insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to unrelated persons in that country;
- is engaged in the insurance business;
- would be subject to tax under subchapter L of the Internal Revenue Code, that is, the insurance company provisions set forth in sections 801-848, if it were a domestic corporation; and
- 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. 

For purposes of this 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; 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. Furthermore, for income to constitute qualified insurance income, it generally must be received from an unrelated person and be derived from the investments made by a qualifying insurance company or 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 health insurance contracts during the tax year and 10 percent of its reserves for life insurance or annuity contracts.

Finally, for purposes of the qualified insurance income determination, 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 United States. However, two special limits apply:

- 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.
- 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

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At present, section 954(i) — like section 954(h) — applies to tax years of foreign corporations starting before 2014 (and tax years of U.S. shareholders with or within which any tax year of the foreign corporation ends). See section 953(e)(10). The implication of the Inversion Notice 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, the Inversion Notice may portend the extension of that provision.

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

See section 953(e)(3)(B); see also section 953(e)(4) (defining the term “qualifying insurance company branch”). The premiums of a branch will be taken into account to the extent that they are treated as earned by the branch in its home country for purposes of that country’s tax laws. See section 953(e)(3)(B) (flush language).

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See section 953(e)(2)(B)(ii).

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

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

See section 953(e)(2)(B); see also section 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).
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. 44

In view of the preceding discussion, the Inversion Notice seems to contemplate that, under the section 954(i) exclusion, foreign group nonqualified property will not include the passive assets held by a foreign corporation or its insurance branches if (i) the foreign corporation is regulated as an insurance (or reinsurance) company in its home country; (ii) the foreign corporation and each of the insurance branches are authorized to sell insurance, reinsurance, or annuity contracts to unrelated persons in their respective home countries; (iii) the foreign corporation is engaged in an insurance business; (iv) the foreign corporation and each of the insurance branches conduct substantial activity with respect to that insurance business in their respective home countries; (v) the foreign corporation and each of the 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; (vi) the foreign corporation would be subject to tax as an insurance company if it were a domestic corporation; (vii) the foreign corporation and the 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; and (viii) the foreign corporation and each of the 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, but only to the extent that such assets are held as investments by the foreign corporation or the insurance branches in support of their exempt contracts or required surplus and give rise to income from unrelated persons. Thus, if these requirements are satisfied by the foreign acquiring corporation or any of its pre-inversion foreign subsidiaries that are members of the EAG, one probably should not expect the passive assets held by such corporation to be treated as foreign group nonqualified property for purposes of the cash box rule.

E. Observations and Recommendations

A review of the exclusions from foreign group nonqualified property included in the Inversion Notice 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 sections 1297(b)(2)(A) and 954(h) for the former group versus the more restrictive rule of section 954(i) for the latter group suggests that a strategic decision was made on the part of 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 the Inversion Notice, although one could speculate that the decision reflects concerns expressed by some regarding “overcapitalized” foreign reinsurers. 45

In the absence of further clarification from Treasury and the IRS, the disparate treatment afforded foreign insurers and reinsurers in the Inversion Notice could have a chilling effect on acquisitions of domestic corporations (whether insurance companies or otherwise) by those companies, 46 just at a time when their interest in completing those acquisitions is picking up. 47 In this regard, the following points are worth keeping in mind:

• Acquisitions made by insurance and reinsurance companies often include an equity component to the consideration on account of regulatory, rating 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 avoided through a foreign corporation’s using only cash consideration to acquire a domestic

44 See section 953(e)(2)(C).


46 Cf. Adam Cancryn and 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.”).

47 Cf. Katie Darden, “Look to Asia for US Insurance Acquirers,” SNL Financial (Oct. 21, 2014) (“The blockbuster acquisition of a U.S. life insurer by a large Japanese institution may be a tough act to follow, but it appears to be part of a geographical trend in insurance M&A. . . . Chinese companies are seeking a long-term platform and presence in the U.S. They are looking at the mature U.S. retirement and insurance market to see what they can learn and take back home with them. This interest extends to U.S. assets beyond insurance.”).
target, that avenue oftentimes is not practical or available for a foreign insurer or reinsurer.

- As discussed above, the exclusions from foreign group nonqualified property appear to be limited to the passive assets held by the foreign acquiring corporation and its pre-inversion foreign subsidiaries that are members of the EAG. However, if the foreign acquiring corporation has any pre-inversion domestic subsidiaries that are members of the EAG, the passive assets held by such subsidiaries apparently will not be eligible for any of the exclusions, resulting in their being treated as foreign group nonqualified property for purposes of the cash box rule. To the extent that this result was intended by Treasury and the IRS in the Inversion Notice, it should be explicated in the regulations implementing the cash box rule.

- Although large, long-established foreign insurers may have the wherewithal to satisfy the requirements of the section 954(i) exclusion, some of those companies nonetheless could be caught by the cash box rule if they already own domestic subsidiaries that hold passive assets (per the point raised in the preceding bullet). Thus, the Inversion Notice effectively creates a class of “winners” and a class of “losers” among otherwise similar companies. In any event, foreign insurers 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 that equity consideration is used to complete the transaction.

- 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 country 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).

One potential solution to the overreach of the cash box rule in the context of acquisitions by foreign insurers and reinsurers would be to replace the section 954(i) exclusion with an exclusion that incorporates section 1297(b)(2)(B). 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.” Thus, unlike section 954(i), which focuses on the location of the risks being insured or reinsured by the foreign corporation, section 1297(b)(2)(B) focuses on the status of the foreign corporation as an insurance company for U.S. federal tax purposes. Although the scope of section 1297(b)(2)(B), like that of section 1297(b)(2)(A), continues to be refined, an exclusion incorporating that provision nevertheless would offer a more practical alternative than the section 954(i) exclusion and would be on par with the section 1297(b)(2)(A) exclusion.

A bolder solution to the overreach of the cash box rule in this context would be the recognition by Treasury and the IRS that, 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 nevertheless are not “passive” from the company’s perspective. Rather, in the company’s view, those assets fill much the same role as the raw materials used in the widget press of a widget manufacturer. While that approach might be viewed by some as a radical departure from the “established” thinking regarding insurers and reinsurers and the nature of the assets required to support their insurance businesses, it nevertheless would remove unnecessary tax complexity and very likely would be welcomed by insurers and reinsurers both in the United States and abroad.

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Cf. William R. Pauls et al., “FATCA Regs Come Up Short for P&C Insurance Industry,” Law360 (Mar. 10, 2014) (“Although the new FATCA regulations address certain concerns of the P&C insurance industry, they fail to respond to the industry’s two primary comments. First, insurance companies, like all other businesses, should be excepted from the reporting and withholding rules that apply to NFFEs if they are actively engaged in the insurance business. By carrying forward the previous definition of active into the new FATCA regulations, the Treasury Department and IRS have effectively eliminated any realistic possibility that there will ever be an insurance company that would fall under the exception for ‘active NFFEs.’ See Temp. Treas. Reg. Section 1.1472-1T(c)(1)(iv); cf. Treas. Reg. Section 1.1472-1(c)(1)(iv).”