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LEGAL ALERT

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FATCA NFFE Rules Subject Non-U.S. P&C Insurers and Reinsurers to Burdensome Reporting Requirements

The good news is that, under the recently released Foreign Account Tax Compliance Act (FATCA) regulations, most non-U.S. property and casualty (P&C) insurance and reinsurance companies will not be considered foreign financial institutions (FFIs) under section 1471 of the Internal Revenue Code and therefore will not be subject to the complex reporting and withholding regime imposed on FFIs. As non-FFIs, however, these entities will constitute “non-financial foreign entities” (NFFEs) and, absent qualification for one or more exceptions set forth in the regulations, will be subject to the reporting and withholding rules under section 1472 of the Code.

Some companies will be exempt from the NFFE rules because their stock is regularly traded on an established securities market, or they are a member of the same expanded affiliated group (EAG) as a corporation whose stock is regularly traded on an established securities market. However, non-regularly traded NFFE insurers and reinsurers will find it difficult to comply with the other exceptions to the NFFE rules, including those for active NFFEs. The difficulty arises because of regulation section 1.1472-1(c)(iv), which requires that, for an insurance company to be considered active, less than 50% of its gross income must be passive income and less than 50%of its assets must be assets that produce or are held to produce passive income. Moreover, in defining “passive income,” the regulations treat income derived by an insurance company in connection with its reserves as passive income. Based on these regulations, many non-regularly traded NFFE insurers and reinsurers will fail to satisfy the mathematical test to be considered “active NFFEs,” notwithstanding that many of these entities will be engaged in the active conduct of an insurance or reinsurance business.

Under the current FATCA rules, those non-regularly traded, non-U.S. P&C companies will suffer 30% withholding on withholdable payments made to them unless they (i) certify to each respective withholding agent that they have no “substantial U.S. owners” (*i.e.*, a U.S. 10% direct or indirect shareholder), or (ii) provide such withholding agent with the name, address, and TIN of each substantial U.S. owner. Where the NFFE has one or more substantial U.S. owners, the withholding agent must, in turn, provide this information to the Internal Revenue Service (IRS). For this purpose, withholdable payments include not only interest and dividends but also insurance and reinsurance premiums covering U.S. risks. The IRS specifically rejected industry comments to exclude these premiums from the definition of withholdable payments as they have done for chapter 3 withholding under section 881 of the Code.

This reporting regime will adversely affect NFFE insurers and reinsurers, their U.S. policyholders, cedents, brokers, and the IRS. Requiring non-U.S. insurance or reinsurance companies to provide information regarding their U.S. shareholders to their U.S. policyholders, cedents, and brokers raises significant confidentiality and commercial issues for these entities. In addition, requiring an insurer’s or reinsurer’s U.S. policyholders, cedents, and brokers to act as the intermediaries for transmitting ownership information to the IRS may catch such persons unaware because they do not have withholding and reporting obligations for premiums under chapter 3. Further, the reporting regime will put unnecessary strain on the IRS processing systems because it will result in mountains of duplicative information being sent to the IRS, especially as each and every report that an insurer or reinsurer provides to its U.S. policyholders, cedents, and brokers would contain the identical information regarding that company's substantial U.S. owners.

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In light of the above concerns, the IRS should (1) adopt rules similar to those under the chapter 3 withholding rules that exclude insurance premiums from the definition of withholdable payments, and (2) provide an alternative rule for determining when an insurance company is entitled to the active trade or business exception under the NFFE rules.

Whether or not the IRS adopts these suggestions, it should permit NFFEs to provide any required information regarding their substantial U.S. owners directly to the IRS and treat such NFFEs as excepted NFFEs if they do. Under this approach, (i) NFFEs would not be required to share potentially sensitive ownership information with others who are not subject to confidentiality or privacy limitations, such as their policyholders, cedents, and brokers, (ii) NFFEs' U.S. policyholders, cedents, and brokers would not be required to incur the expense and exposures associated with acting as intermediaries, and (iii) the IRS would receive a single annual report from each NFFE with the information regarding its substantial U.S. owners. This approach would provide the IRS with all of the information it is required to collect under FATCA and would mitigate many of the commercial and confidentiality issues that exist under the current reporting regime.

Alternatively, the IRS should consider permitting direct IRS reporting for NFFEs under an IGA. Many of the NFFEs that will be impacted by these rules will be located in jurisdictions that will enter into IGAs. However, even if a jurisdiction enters into an IGA (either a Model I or Model II IGA), IGAs do not address the treatment of NFFEs. Although it is not surprising that IGAs focus on FFIs because FFIs have the burden of identifying and reporting U.S. account holders, consideration should be given to the treatment of NFFEs under FATCA. The issues confronting NFFEs, including the application of privacy laws that may prevent FATCA compliance, need to be addressed prior to the implementation of FATCA.

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