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Implications of final U.S. debt-equity treasury regulations for insurance company groups

Specific responses to issues raised by the global insurance industry

31 October 2016

The following bullet points summarize some of the key comments the global insurance industry sent the Treasury and IRS on the Proposed Regulations and how those comments were addressed in the Final Regulations.

1. **Life/nonlife insurance consolidated groups**

   — **Issue:** Absent meeting special requirements, life and nonlife insurance companies often are prohibited from being members of the same consolidated group for U.S. federal income tax purposes.[1] The Documentation Rule, General Rule, and Funding Rule do not apply to a debt instrument held by a member of a U.S. consolidated tax group of which the issuer is also a member. As a result, transactions between some related life and nonlife companies cannot benefit from the consolidated group exception, and thus may be subject to recharacterization under the Proposed Regulations.

   — **Insurance industry proposed solution:** Allow affiliated life and nonlife companies to be treated as a single taxpayer for purposes of the regulations — in effect, expanding the scope of the consolidated group exception to cover life and nonlife affiliated groups.

   — **Treasury department and IRS response:** The suggestion to expand the exception to include certain insurance companies that are prohibited from joining the group under Section 1504(c) was considered but not ultimately adopted. The rationale was that none of the obligations would be governed by the consolidated return regulations, which are deemed to be sufficiently comprehensive as to warrant the exclusion of these obligations from the rules. Therefore, while most regulated insurance companies would be exempt from the General Rule and the Funding Rule, the Documentation Rule could still apply to

1 Filing as a consolidated group allows an affiliated group of corporations to centralize the planning, reporting and paying of tax. The corporate parent acts as the group's agent in filing the consolidated tax return and paying the federal tax liability. The advantages of filing as a consolidated group include offsetting the profits and losses of group companies against each other, netting out capital gains and losses of group companies, no tax on intercompany distributions, deferring income on intercompany transactions, and the ability to use one group company's unused foreign tax credit by another group company.

EGIs between affiliated insurance group members where both affiliates do not belong to the same consolidated group.

2. **Ordinary course exception to General Rule**
   - **Issue:** The Proposed Regulations provide an exception to the General Rule for debt instruments that arise in the ordinary course of the issuer's trade or business (the "Ordinary Course Exception"). Ordinary course obligations are defined as those that would be deductible as a customary trade or business expense or included in cost of goods sold or inventory. This exception may be difficult for insurers to meet.
   - **Insurance industry proposed solution:** Clarify the application of the Ordinary Course Exception for insurers.
   - **Treasury department and IRS response:** While the Ordinary Course Exception was not specifically extended to cover insurance transactions, qualifying regulated insurance companies are exempt from the application of the General Rule.
3. **Funds-withheld reinsurance**
   - **Issue:** Some funds-withheld reinsurance arrangements in theory may be characterized as debt for U.S. tax purposes. Under a funds-withheld arrangement, some or all of the consideration normally due the reinsurer is not paid, but rather is withheld by the ceding company, often to permit statutory credit for non-admitted reinsurance, to reduce the potential credit risk, or to retain control over investments. Such arrangements may have difficulty meeting the Documentation Rule and consequently could be recharacterized as equity.
   - **Insurance industry proposed solution:** Either exclude funds-withheld arrangements from the application of the regulations, or expand the Ordinary Course Exception to the General Rule to cover such arrangements.
   - **Treasury department and IRS response:** The preamble to the Final Regulations provides that reinsurance and funds-withheld reinsurance are not debt in form and are typically governed by the terms of a reinsurance contract (and other ancillary contracts). As such, such funds-withheld reinsurance arrangements generally are not debt instruments subject to the application of the Final Regulations.
4. **Surplus notes**
   - **Issue:** Surplus notes are financial instruments issued by insurance companies that pay interest after all other contractual payments are made and generally are treated as debt for U.S. tax purposes. Surplus notes have hybrid characteristics that differ from those of traditional debt, such as contingencies including pre-approval by state insurance regulators prior to repayment of principal and interest, and the ability to defer payments without facing default until the insurance companies have a surplus. As a result, it may be difficult for surplus notes to meet the Documentation Rule, which generally requires evidence of a bona fide debtor creditor relationship and an unqualified obligation to repay. Recharacterization under the Proposed Regulations may result in treatment as equity or part debt and part equity under the Bifurcation Rule.
   - **Insurance industry proposed solution:** Either exclude surplus notes from the application of the regulations, or expand the Ordinary Course Exception to the General Rule to cover surplus notes.
   - **Treasury department and IRS response:** Under the Final Regulations, a surplus note issued by a regulated insurance company satisfies the Documentation Rule as long as it is

expected at the time of issuance that the surplus note will be paid in accordance with its terms and proper documentation is prepared and maintained to support such expectation. A surplus note is considered to satisfy the Documentation Rule even if it requires the issuer to receive approval or consent of an insurance regulatory authority before making payments of principal or interest. Further, regulated insurance companies are exempt from the General Rule.

5. Foreign tax credit

— **Issue:** Insurance companies often operate outside the United States through CFCs rather than disregarded or tax transparent entities. The Proposed Regulations may have recharacterized debt issued by a CFC as nonvoting equity; interest and principal payments on a debt so recharacterized would have been treated as distributions, taxable as dividends to the extent of the CFC's earnings and profits. U.S. foreign tax credits ("FTCs") are available to certain U.S. shareholders of a CFC on payment or deemed payment of dividends to eliminate double taxation of foreign earnings. The recharaterization of a CFC related party debt as nonvoting equity may cause FTCs to be unavailable, potentially resulting in double taxation.

— **Insurance industry proposed solution:** Either allow recharacterized debt to qualify for FTCs to the extent an actual dividend would have qualified if paid to existing shareholders within the expanded group immediately prior to the recharacterization of the debt, or if interest and principal payments are recharacterized, allow the entities to be treated as one corporation in determining the E&P and FTC consequences of the payments, so that the treatment for U.S. shareholders generally would apply.[2]

— **Treasury department and IRS response:** Foreign issuers are generally exempt from the application of regulations, so the concern is eliminated (for now). However, the preamble to the Final Regulations states that the Treasury and IRS believe that the application of the regulations to foreign issuers requires further study, so new regulations may be forthcoming in the future.

6. Earning and profits exception to General Rule and the Funding Rule

— **Issue:** The Proposed Regulations contained an exception to the General Rule and the Funding Rule for distributions or acquisitions that do not exceed the issuing company's current year earnings and profits ("E&P"). However, property-casualty insurers may find it difficult to qualify for this exception. Earnings are volatile due to the unpredictability of catastrophes and other losses, making current-year E&P nearly impossible to accurately predict in advance. In addition, payment of dividends is subject to local law limitations and often requires regulatory approval to ensure that adequate capital is maintained and earnings are re-invested, making it unusual for earnings to be distributed on an annual basis.

— **Insurance industry proposed solution:** Rather than using current E&P, allow the earnings and profits exception to be for an amount equal to the cumulative sum of the member's most recent five years of net undistributed E&P.

— **Treasury department and IRS response:** The E&P exception has been expanded to take into account a corporation's E&P accumulated after April 4, 2016 (as opposed to limiting distributions to the amount of E&P generated in the current year). Moreover,

2 This is an existing concept under the Regulations, which treat all members of a consolidated group as one corporation.

regulated insurance companies should generally be exempt from the application of the General Rule and the Funding Rule.[3]

7. Reinsurance contract

- **Issue:** Reinsurance contracts do not have common debt characteristics, but the Proposed Regulations did not clearly exclude them from their application. Reinsurance contracts are subject to a well-developed body of law and regulations, and do not fall within the definition of a "debt instrument" under other sections of the Internal Revenue Code. Moreover, reinsurance payments are unlike debt payments because they depend upon the occurrence of a contingency named in the contract, and not upon a prescribed schedule for payment of principal and interest. Insurance companies do not purchase reinsurance for general debt-financing purposes, but rather in order to stabilize loss experience, increase underwriting capacity, relieve strain on "surplus" (or capital) to comply with regulatory guidelines, and protect against catastrophes.
- **Insurance industry proposed solution:** Clarify that reinsurance contracts will not be within the scope of the regulations. This view is especially supported by the fact that reinsurance contracts do not offer the risk of tax avoidance that is the target of the regulations, because (A) there is an extensive body of law governing the treatment of reinsurance contracts and (B) reinsurance contracts are issued only between two insurance companies and are subject to regulatory review.
- **Treasury department and IRS response:** Insurance and reinsurance contracts generally are not subject to the Final Regulations because they have generally not been treated as debt instruments under existing law. However, to the extent that a reinsurance contract is treated as an EGI, it would not be treated differently from other debt instruments, except for the exemption for EGIs issued by regulated insurance companies from the General and Funding Rules.

8. Cash pools

- **Issue:** Reinsurers that are part of a multinational insurance group may use global cash pools, such as notional cash pool arrangements,[4] to meet short term cash needs within the group. This kind of arrangement generally is a short-term financing transaction that does not create the erosion of the U.S. tax base, but may have been subject to the Proposed Regulations.
- **Insurance industry proposed solution:** Exclude cash pool arrangements from the application of the regulations.
- **Treasury department and IRS response:** The regulations provide an exception to the General Rule and Funding Rule for short-term loans among affiliates to cover cash pooling, cash sweeping and similar arrangements.

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3 Consequently, it will be important to track E&P. Certain M&A activity and other transactions may limit the ability to use historical E&P for this purpose.

4 Notional cash pool arrangements are a method acceptable to insurance regulators to manage liquidity across multiple entities in multinational affiliated groups without co-mingling of funds. It is a structure involving several related accounts whose balances have been aggregated for the purposes of optimizing interest paid or received.

If you have questions about the Final Regulations and how they could affect your insurance or reinsurance group, we would be happy to assist you.

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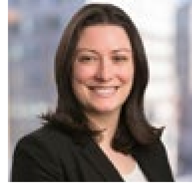

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