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

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Proposed Treasury regulations released earlier this year addressing the U.S. tax treatment of related-party debt caused widespread alarm across the insurance industry, mainly because of their far-reaching scope. Final regulations released in October, however, significantly narrow and relax the proposed regulations but continue to impose significant compliance burdens and impact many related-party financing transactions. This note highlights key provisions of the final regulations that have particular impact on insurance company groups.

Background

On April 4, 2016, the U.S. Internal Revenue Service ("IRS") and the U.S. Treasury Department ("Treasury") issued proposed regulations under Section 385 of the Internal Revenue Code (the "Proposed Regulations") that would reclassify certain instruments that are debt in form as equity for U.S. income tax purposes. The Proposed Regulations were part of the IRS' efforts to curtail perceived benefits of inversion transactions and certain forms of U.S. earnings stripping, such as debt pushdowns that introduce debt through note distributions by U.S. subsidiaries to foreign shareholders in the "inbound" context, and transactions in which U.S.-parented groups use debt to repatriate low-taxed earnings and profits held by foreign corporations in the "outbound" context. The Proposed Regulations would, in certain circumstances, have recharacterized debt instruments issued between members of an "expanded group" as stock or as part stock and part debt for U.S. federal income tax purposes. Debt instruments subject to the regulations are referred to as expanded group instruments ("EGIs").

The Proposed Regulations

The Proposed Regulations contained:

1. a "**General Rule**" that treats as stock (i) debt instruments distributed to a related party, (ii) debt instruments issued to acquire stock of a related party, and (iii) debt instruments distributed to a related entity as "boot" in an asset acquisition;
2. a "**Funding Rule**" that generally characterizes a related-party debt instrument as stock if that instrument is used to fund (i) the distribution of a dividend, (ii) the acquisition of stock in a related entity, or (iii) the distribution of "boot" in an asset reorganization, with debt issued either 36 months before or after the relevant transaction generally being treated as issued with such a principal purpose;

3. a "**Documentation Rule**" that would recharacterize as equity debt if the parties failed to prepare and maintain loan documentation supporting debt treatment — including an unconditional obligation to pay a sum certain, creditor's rights to enforce the terms of the EGI, reasonable expectation of the borrower's ability to repay the EGI, and actions evidencing a genuine debtor-creditor relationship — within 30 days of issuance; and
4. a "**Bifurcation Rule**" that allows the IRS to treat related-party debt as in part equity and in part debt in some cases.

(See summary of the proposed regulations by Hogan Lovells here.)

Insurance industry response to the Proposed Regulations

The Proposed Regulations were heavily criticized as being a departure from existing law, where courts generally have applied a long-standing multifactor analysis to distinguish debt from equity, and instead focused almost exclusively on the relationship of the parties to the instrument, the context in which it was issued, and the relevant documentation to determine whether there is sufficient support for debt treatment. The IRS received an overwhelming number of public comments (a total of 29,780) to the Proposed Regulations, and many insurance groups and trade associations were among the commenters.

Final and temporary regulations

On October 13, 2016, final and temporary regulations (the "Final Regulations") were released. Perhaps because of the pervasive opposition to many aspects of the Proposed Regulations, the preamble to the Final Regulations includes detailed responses to many of the public's comments and an unusually lengthy justification for the new debt-equity rules, explaining that the Final Regulations should affect only 1,200 corporate groups, mostly large taxpayers with closely related affiliates that issue debt instruments. Many of the changes in the Final Regulations narrow and relax the Proposed Regulations both generally and with respect to insurance groups.

The final and temporary regulations

Exemptions for foreign issuers

The Final Regulations do not apply to foreign issuers of debt, such as foreign insurance groups, including foreign holding companies, foreign insurance and reinsurance companies, foreign investment or special purpose subsidiaries, and foreign service company affiliates (but Treasury officials warn that they are reexamining such rules and may issue regulations in the future that apply to foreign issuers). As a result, in their current form the Final Regulations generally are restricted to the domestic and "inbound" contexts involving foreign parented groups. Domestic companies, including domestic holding companies and LLCs treated as domestic corporations for federal income tax purposes, as well as foreign insurance controlled foreign corporations ("CFCs") that made an election to be treated as a domestic corporation pursuant to Sec. 953(d), are still subject to the regulations but may benefit from the new carve-outs, as described herein.

Exemptions for short-term loans

The Final Regulations generally exclude short-term loans, including cash pool arrangements.

Partial exemption for regulated insurance companies

While domestic insurance companies are not entirely exempted from the regulations, EGIs issued by "regulated insurance companies" are exempted from the application of the General Rule and

Funding Rule.[1] The rationale for the exemption is that such entities are subject to stringent state insurance regulations and therefore have limited ability to issue instruments inappropriately characterized as debt. Certain insurance captives are not considered to be regulated insurance companies qualifying for this exemption because such companies generally are not subject to the same risk-based capital requirements and are otherwise not subject to regulation and oversight to the same degree as other insurance and reinsurance companies. Members of insurance company groups that are not themselves regulated insurance companies, such as holding companies and service companies, are also excluded from the exemption because they are not directly subject to state insurance regulations. A foreign insurance CFC treated as a domestic company under Sec. 953(d) is not exempted as a foreign issuer because it is treated as a domestic company and presumably would not be subject to the partial exemption as a regulated insurance company, assuming it is not subject to state insurance regulations.

While EGIs issued by regulated insurance companies are still subject to the Documentation Rule, the Documentation Rule has been relaxed, particularly with respect to surplus notes.

Partial exemption for regulated financial entities

A similar exemption also exists for regulated financial entities, such as banks, bank holding companies, registered broker dealers and certain affiliates.[2] The rationale is similar to the partial exemption for regulated insurance companies — the regulatory regime imposes capital or leverage requirements that have the effect of limiting the extent to which a regulated company can increase the amount of its debt. An EGI issued by an excepted regulated financial company is considered to meet the Documentation Rule as long as it contains terms required by a regulator of that issuer in order for the EGI to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation.

Modification of the specific rules

The **General Rule** and the **Funding Rule** generally will have effect beginning on January 19, 2017 — 90 days after the official implementation of the Final Regulations. To prevent abuse, payments made on certain debt instruments outstanding after April 4, 2016 but repaid before January 19, 2017 may nonetheless be subject to recharacterization.

The **Documentation Rule** has been narrowed to apply to an expanded group only if (i) the stock of any member of the expanded group is publicly traded, (ii) all or any portion of the expanded group's financial results are reported on financial statements with total assets exceeding $100 million, or (iii) the expanded group's financial results are reported on financial statements that reflect annual total revenue exceeding $50 million. Further, the Documentation Rule has been relaxed with regard to insurance companies in a number of ways. First, the Documentation Rule does not apply until January 1, 2018. Second, an issuer is not required to document debt instruments until the due date of its tax returns (including any applicable

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1 A regulated insurance company is defined as a member of an expanded group that is (i) subject to tax under subchapter L of chapter 1 of the Code, (ii) domiciled or organized under the laws of a state or the District of Columbia, (iii) licensed, authorized, or regulated by one or more states or the District of Columbia to sell insurance, reinsurance, or annuity contracts to persons other than related persons, and (iv) engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance, or annuity contracts with persons that are not related persons (within the meaning of section 954(d)(3)). A corporation will not satisfy the licensing, authorization, or regulation requirements if a principal purpose for obtaining such license, authorization, or regulation was to qualify as a "regulated insurance company" under the Final Regulations.

2 Other regulated financial entities include certain savings and loan holding companies, insured depository institutions and any other national banks or state banks that are members of the Federal Reserve System, nonbank financial companies subject to a determination by a Financial Stability Oversight Council, certain U.S. immediate holding companies formed by foreign banking organizations, Edge Act and agreement corporations, supervised securities holding companies, futures commission merchants, swap dealers, security-based swap dealers, federal home loan banks, farm credit system institutions, and small business investment companies.

extensions) for the year of issuance. Third, the regulations provide that an expanded group that demonstrates a "high degree of compliance" with the documentation requirements will not be subject to automatic equity recharacterization for isolated instances of noncompliance.[3] A noncompliant instrument issued by such an expanded group would be classified using the multi-factor analysis of existing law, but the group will carry the evidentiary burden to rebut a presumption that the instrument is equity. If an expanded group does not demonstrate a high degree of compliance with the Documentation Rule, such noncompliant EGI would be treated as stock for federal tax purposes. Fourth, the regulations provide a "market standard safe harbor," whereby the documentation requirements can be satisfied with documentation of a kind customarily used in comparable third-party transactions. Finally, an EGI, such as "surplus notes," issued by a regulated insurance company is considered to satisfy the Documentation Rule even though the instrument requires the issuer to receive approval or consent of an insurance regulatory authority before making payments of principal or interest on the debt instrument.[4]

The **Bifurcation Rule** was abandoned, but the IRS notes it will continue to study the need for such a rule. It is possible that this will be addressed by the Treasury Department under the next presidential administration.

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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3 An expanded group is considered to have a high degree of compliance if (1) the average total adjusted issue price of all outstanding EGIs that do not comply with the Documentation Rules is less than 10 percent of the average amount of total adjusted issue price of all EGIs that are outstanding as of the close of each calendar quarter or (2) no noncompliant EGI has an issue price in excess of a threshold that varies based on the percentage of noncompliant EGIs a group has.

4 However, the parties must expect at the time of issuance that the debt instrument will be paid in accordance with its terms and that the parties prepare and maintain the documentation necessary to establish that the instrument in question qualifies for the exception.

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