Executive summary

On 13 October 2016, the US Internal Revenue Service (IRS) and US Treasury Department (Treasury) released much-anticipated final and temporary regulations (TD 9790) under Section 385 (the Section 385 Regulations). The Section 385 Regulations will significantly affect domestic and foreign (non-US) insurance companies, despite repeated concerns voiced by the business community and the insurance industry.

While the Section 385 Regulations will significantly affect insurance companies, they offer a welcome relief for characterizing related-party debt as compared to the proposed regulations issued on 4 April 2016. Such relief is brought through the inclusion of numerous exceptions and exclusions from the proposed regulations, including specific carve outs for regulated insurance companies and certain debt instruments issued by those companies as discussed below.

The final and temporary regulations generally recharacterize certain related-party debt as stock when:

- Documentation requirements are not met (the “Documentation Rule” in Treas. Reg. Section 1.385-2).

- Debt is issued in conjunction with regard to certain distributions, asset acquisitions or stock acquisitions (the “Recharacterization Rule” in Treas. Reg. Sections 1.385-3 and -3T).
The Recharacterization Rule generally applies to tax years ending on or after 90 days after the final regulations are published in the Federal Register (i.e., 19 January 2017). It does not apply to debt instruments issued before 5 April 2016. The Documentation Rule generally applies to debt instruments issued on or after 1 January 2018.

The Section 385 Regulations make substantial changes to the proposed regulations, including:

**Excluding foreign issuers:** The Section 385 Regulations apply only to issuers that are domestic corporations (including, among others, Section 953(d) companies and disregarded entities with domestic corporate owners). The Treasury has “reserved”, and requested comments, on the treatment of related-party interests issued by foreign issuers (including any US branch that they may own).

**Exclusions involving certain financial institutions**

- **Documentation Rule**
  - The Documentation Rule includes more flexible requirements for, among others, insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.
  - The Documentation Rule does not apply to reinsurance and funds-withheld reinsurance. Treasury did not agree with commentators that there is a need for guidance on reinsurance or funds-withheld reinsurance. As explained in the Preamble, this is because the Documentation Rule only applies to instruments that are “debt in form,” and such insurance arrangements are not debt in form.

- **Recharacterization Rule**
  - Similarly, the Preamble states that insurance and reinsurance contracts would not generally be subject to the Recharacterization Rule because those contracts are not ordinarily treated as debt instruments as defined in the Recharacterization Rule.
  - Treasury determined that debt instruments issued by domestic regulated insurance companies should be excluded from the Recharacterization Rule. As discussed in more detail later, Treasury provided for a specific definition for what qualifies as a regulated insurance company.

**Eliminating the bifurcation rule:** The Section 385 Regulations do not include the “bifurcation rule” included in the proposed regulations, under which the IRS was permitted to characterize certain instruments within a “modified expanded group” as part debt and part stock.

Other significant changes to the proposed regulations include a widely anticipated cash pooling exception, expanded exceptions for ordinary course transactions, changes to the determination of earnings and profits (E&P) for purposes of the Recharacterization Rule, exceptions for certain other entities subject to special treatment under the Internal Revenue Code such as REITS and RICs, and exceptions for statutory debt instruments such as regular REMIC interests and production payments. EY will be publishing separate alerts on the Section 385 Regulations that are not insurance-specific.

**Detailed summary**

**Foreign issuers exempt from Section 385 regulations**

The final and temporary regulations apply only to debt instruments issued by members of an expanded group that are domestic corporations (including corporations treated as domestic corporations for federal income tax purposes, such as under Sections 953(d), 1504(d), or 7874(b)). The final and temporary regulations achieve this result by creating the term “covered member,” which is defined as a member of an expanded group that is a domestic corporation, and reserves on the inclusion of foreign corporations. The Preamble states that Treasury and the IRS have determined that the application of the final and temporary regulations to indebtedness issued by foreign corporations requires further study. Comments are invited on their application to foreign members.

**EY Comment:** As compared to the proposed regulations, the exclusion of foreign issuers should significantly reduce the compliance burden and planning impact on US-based multinationals with respect to intercompany debt issued by foreign entities. Foreign-based multinationals and certain other groups in which foreign or other non-consolidated expanded group members hold covered debt instruments, however, are likely to be significantly affected.

The Documentation Rule and the Recharacterization Rule may also have effect beyond their explicit scope. With respect to the Documentation Rule, the preamble to the Section 385 Regulations indicates that Treasury and IRS considered the documentation requirements contained in the Documentation Rule as “best documentation practices under case law,” and therefore may be considered as a valuable guidepost on how the IRS may evaluate the
character of an intercompany debt instrument issued by a foreign entity, even if the instrument is not strictly subject to the Section 385 Regulations. With respect to the Recharacterization Rule, the exclusion of foreign issuers from the Recharacterization Rule will likely enliven certain planning strategies, such as repatriation transactions, restructuring transactions and other transactions in which intercompany debt is issued by foreign entities, which strategies otherwise might have been curtailed by the proposed regulations. Given that the final and temporary regulations have set forth numerous new and complex rules on applying the regulations to E&P, reorganizations and group restructurings that could apply to foreign corporate issuers, however, the framework is in place to apply both the Recharacterization Rule and the Documentation Rule in the regulations to foreign corporate issuers in the future. The Preamble contemplates this potentiality, but states that any subsequently issued guidance addressing the comments received will not apply to interests issued before the date of such guidance. Finally, and more generally, due to the breadth and complexity of the final and temporary regulations, it is likely that they will affect ordinary-course business transactions in myriad unforeseen ways.

The Treasury and the IRS indicated in the preamble and in a contemporaneous press release that the final and temporary regulations are intended to narrowly target transactions that erode the US tax base. Indeed, by reserving on the application of the regulations to foreign issuers, the Obama Administration has substantially limited the scope of the final and temporary regulations, at least as compared with the proposed regulations, while leaving the option open to future Treasury Departments to determine whether application of the recharacterization and documentation requirements should ever apply to foreign issuers.

Documentation Rule excludes reinsurance, funds-withheld reinsurance
Comments submitted to Treasury requested an ordinary course exception to the documentation rules applicable to all payments on insurance contracts, funds-withheld arrangements in connection with reinsurance, funds-withheld reinsurance, and surplus notes. The Preamble states that Treasury and the IRS do not agree that there is a need for guidance on reinsurance or funds-withheld reinsurance, because these agreements are not “debt in form” and are typically governed by the terms of a reinsurance contract (and other ancillary contracts). Treasury and the IRS conclude in the Preamble that such arrangements “are not covered EGIs under the final regulations” governing the documentation requirements.

EY Comment: Although there is no explicit exclusion in the Documentation Rule for reinsurance or funds-withheld reinsurance, the Preamble should provide guidance to insurance companies that Treasury and the IRS view such arrangements as outside the scope of the documentation rules.

Documentation Rule includes relaxed requirements applicable for surplus notes and similar instruments
The insurance industry expressed concern about certain instruments utilized for regulatory capital purposes, such as surplus notes, that may contain features that could cause the instrument to fail to meet the Documentation Requirements as set forth in the proposed regulations.

For example, if a borrower’s obligation to pay interest or principal, or a holder’s right to enforce such payment, is conditioned upon the issuer receiving regulatory approval, but the instrument otherwise satisfies the unconditional obligation to pay a sum certain and creditor rights factors, comments argued that the required regulatory approval should not prevent the interest from being treated as debt. Similarly, comments requested the final regulations to provide that, if regulatory approval delays an action, that delay will not prevent an issuer from satisfying the timeliness requirement. The final regulations provide an exception from the documentation requirements for certain instruments issued by a regulated insurance company (as defined in the regulations). Generally, an instrument issued by a regulated insurance company that requires the issuer to receive approval or consent of an insurance regulatory authority prior to making payments of principal or interest on the instrument is excluded from the general documentation requirements, provided that, at the time of issuance, it is expected that the instrument will be paid in accordance with its terms and documentation is prepared and maintained to establish that the instrument in question qualifies for the exception.

EY Comment: Surplus notes or other similar debt instruments issued by regulated insurance companies may be subject to relief from the documentation requirements. A careful analysis of those instruments is still needed, however, to document that they meet the specific documentation requirement involving regulatory approval.
and an expectation of repayment of principal and payments of interest according to the terms. Debt instruments issued by non-regulated entities within an insurance group (e.g., holding companies or service companies) may not be eligible for the exception. In addition, insurance companies may engage in securities lending and other transactions in which cash collateral is posted. As such, collateral arrangements often produce interest income (even though it is generally netted against other payments), so consideration should be given as to how the Documentation Rule applies to these situations.

Insurance and reinsurance contracts not subject to the Recharacterization Rule

The Recharacterization Rule only applies to interests that would, but for the application of Treas. Reg. Section 1.385-3, be treated as debt instruments as defined in Section 1275(a) and Treas. Reg. Section 1.1275-1(d). Treasury and the IRS conclude in the Preamble that “insurance and reinsurance contracts generally would not be subject to (Reg. Section) 1.385-3 because such contracts are not ordinarily treated as debt instruments as defined in [S]ection 1275(a) and [Reg. Section] 1.1275-1(d).” Treasury adds in the Preamble, however, that, “[t]o the extent that an arrangement entered into in connection with an insurance or reinsurance contract would be treated as a debt instrument, as defined in [S]ection 1275(a) and [Reg. Section] 1.1275-1(d), that arrangement is a debt instrument for federal income tax purposes. As a result, the Treasury and the IRS have determined that such a debt instrument should not be treated differently than any other interest subject to [Reg. Section] 1.385-3.”

EY Comment: Although insurance and reinsurance contracts are not treated as debt under Section 1275 and its regulations, careful consideration should be given to instruments treated as debt for US federal income tax purposes that could somehow be viewed as issued “in connection with” an insurance or reinsurance contract.

Recharacterization Rule does not apply to regulated insurance companies

Very generally, the Recharacterization Rule applies to “covered debt instruments,” which are specifically defined in the regulations, and the final and temporary regulations provide that a covered debt instrument does not include a debt instrument issued by a regulated insurance company. This definition, however, does not include certain captive insurance companies as described in the following discussion.

The Preamble states that Treasury and the IRS determined that debt instruments issued by insurance companies that are subject to risk-based capital requirements under state law should be excluded from the definition of covered debt instrument for purposes of the Recharacterization Rule. The Treasury and the IRS determined that, similar to regulated financial companies (e.g., banks), regulated insurance companies are subject to risk-based capital requirements and other regulations that mitigate the risk that they would engage in the types of transactions addressed by the final and temporary regulations.

Treas. Reg. Section 1.385-3(g)(3)(v) defines a regulated insurance company as a covered member 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 (within the meaning of Section 954(d)(3)); and (iv) engaged in regular issuances of (or subject to ongoing liability for) insurance, reinsurance or annuity contracts with persons that are not related persons (within the meaning of Section 954(d)(3)). In order to prevent a company from inappropriately qualifying as a regulated insurance company, the final and temporary regulations also provide that in no case will a corporation 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 and temporary regulations.

Importantly, the last prong of the definition of “regulated insurance company” has the effect of not including within the exclusion certain captive insurance and reinsurance captive companies. The Preamble states that covered debt instruments issued by such companies are not excluded under the final and temporary regulations because captive insurers are not subject to risk-based capital requirements and are otherwise not subject to regulation and oversight to the same degree as other insurance and reinsurance companies.

Further, the Preamble notes that that the determination of whether a debt instrument issued by a member of a consolidated group is a covered debt instrument is made on a separate-member basis without regard to the one-corporation rule for consolidated groups under Treas. Reg. Section 1.385-1(e). Treasury and the IRS explained that separate-member treatment is appropriate for making
this determination because the exceptions to covered debt instrument status are tailored to specific entity-level attributes of the issuer. For example, because status as an excepted regulated financial company is determined on an issuer-by-issuer basis, Treasury and the IRS have determined that it would not be appropriate to extend that special status to other members of a consolidated group that do not meet the specific requirements for the exception. Similarly, Treasury and the IRS have not extended the regulated insurance company exception to other members of an insurance company’s group that are not themselves regulated insurance companies. In explaining this decision, the Preamble states that state insurance regulators only exercise direct authority over regulated insurance companies; such direct authority does not extend to other non-insurance entities within the group. Subsidiaries of insurance companies that are not themselves insurance companies are only subject to regulation indirectly through supervision of the affiliated insurance companies. Among other things, in contrast to a regulated financial group (e.g., banks), such non-insurance subsidiaries and affiliates are generally not subject to consolidated capital requirements.

EY Comment: The Preamble indicates that the intent behind the regulated insurance exception is that insurance companies that are subject to risk-based capital requirements under state law should be excluded from these rules. Rather than adopting a rule that specifically tests the regulatory capital requirements of an insurance company, however, the final and temporary regulations restrict the exception to companies that issue insurance (or reinsurance contracts) to unrelated persons (utilizing the definition of related person under Section 954(d)(3)). As discussed previously, the exception will not apply to non-insurance companies within a group (e.g., holding companies or service companies) and other types of insurance companies that generally engage in related-party insurance or reinsurance (such as certain captives), and the determination of whether a debt instrument is a covered debt instrument is made on a separate-member basis. Accordingly, it appears that a member of a consolidated group that is not a regulated insurance company on a separate-entity basis may not be able to rely on the activities of a consolidated group member that is a regulated insurance company on a separate-entity basis. Finally, the exception does not appear to apply to an insurance company that has made an election under Section 953(d) because those companies are normally organized or domiciled outside the United States.

Special rules not given to life-nonlife groups
Treas. Reg. Section 1.385-1(e) treats members of a consolidated group as one corporation (the one-corporation rule) to prevent application of the regulations to interests between members of a consolidated group. The Preamble states that the proposed regulations did not apply to indebtedness issued by a corporation to members of its consolidated group because the policy concerns addressed in such rules are generally “not present when the issuer’s deduction for interest expense and the holder’s corresponding inclusion of interest income offset on the group’s consolidated federal income tax return.”

The insurance industry submitted comments to Treasury noting that the one-corporation rule in Prop. Treas. Reg. Section 1.385-1(e) would not apply when Section 1504(c)(2) prohibits inclusion of newly acquired life insurance subsidiaries in a consolidated group. Such comments requested that the regulations treat newly acquired life insurance companies as part of a consolidated group even if Section 1504(c)(2) would not treat such companies as part of the group.

The Treasury rejected this request, but the final and temporary regulations, as previously discussed, provide for certain exclusions from the Recharacterization Rule for debt instruments issued by regulated insurance companies. In explaining the rationale for not adopting the industry’s request, the Preamble points out that the one-corporation rule is intended only to treat members of a consolidated group that file a single federal income tax return as a single taxpayer because items of income and expense with respect to debt instruments between such members are included and offset each other on the consolidated group’s single federal income tax return. To the extent that Section 1504(c)(2) prohibits recently acquired life insurance companies from joining a consolidated group, the items of income and expense of the companies and the consolidated group are not included in a single federal income tax return. In this context, a consolidated group and its recently acquired life insurance subsidiaries are not materially different from two separate consolidated groups that are part of the same expanded group. Transactions between two separate consolidated groups that are part of the same expanded group are subject to Treas. Reg. Sections 1.385-3 and 1.385-4T. As a result, Treasury and the IRS declined to include a special rule related to Section 1504(c)(2) in the temporary regulations.
Generally, when a life insurance company issuer becomes a member of the life-nonlife consolidated group (e.g., after the five-year requirement in Section 1504(c)(2) has been met), then it is treated immediately thereafter as issuing a new covered debt instrument to the holder in exchange for a covered debt instrument. See Treas. Reg. Section 1.385-4T(c)(2). The final and temporary regulations also include ancillary rules on re-testing the underlying distribution or acquisition that caused the covered debt instrument to be treated as stock.

*EY Comment:* As Treasury declined to treat newly acquired life insurance companies as part of a consolidated group for purposes of Treas. Reg. Section 1.385-1(e), these insurance companies will need to rely on the exceptions and exclusions previously outlined.

**Comments requested**

Treasury and the IRS requested comments on all of the reserved issues, including, among others: (i) the application of the final and temporary regulations to foreign issuers; (ii) the application of Treas. Reg. Sections 1.385-3 and 1.385-3T to US branches of foreign issuers, in the absence of more comprehensive guidance regarding the application of Treas. Reg. Sections 1.385-3 and 1.385-3T with respect to foreign issuers; (iii) the expanded group treatment of brother-sister groups with common non-corporate owners, including how to apply the exceptions in Treas. Reg. Section 1.385-3(c) to such groups; (iv) the application of Treas. Reg. Section 1.385-2 to instruments that are debt not in form, and (v) rules prohibiting the affirmative use of Treas. Reg. Sections 1.385-2 and 1.385-3. The Treasury and the IRS also request comments on the general bifurcation rule of proposed Treas. Reg. Section 1.385-1(d).

The Preamble states that any subsequently issued guidance addressing these issues will not apply to interests issued before the date of such guidance.

**Recommended next steps**

To better understand the effect of the Section 385 Regulations on your business, we recommend the following approach:

1. Conduct an impact assessment in preparation for the application of the Section 385 Regulations within 90 days.

2. Explore processes and possible technology solutions to monitor debt instruments that are not exempt from the Section 385 Regulations.

3. Begin engaging with internal stakeholders affected by the Section 385 Regulations.
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