# Client Update

## Final Related-Party Debt Regulations Provide Exceptions for Insurance Industry

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The Treasury Department and Internal Revenue Service have issued final and temporary regulations under section 385 of the Internal Revenue Code (the "Final Regulations") addressing the treatment of certain debt instruments issued between related parties as stock for U.S. federal income tax purposes. The Final Regulations include welcome guidance for the insurance industry, including a general exception for regulated insurance companies from key provisions of the regulations.

The Final Regulations, as discussed in more detail in our prior Client Update, take a more limited and taxpayer-friendly approach than the proposed regulations. The Final Regulations do not currently apply to debt issued by foreign corporations and provide important new exceptions (including the regulated insurance company exception). The Final Regulations ease the documentation requirements for related-party debt instruments (including by extending the time frame for producing documentation for debt instruments that are within the scope of the Final Regulations) and include helpful modifications to the equity recharacterization rules (including an expansion of the earnings and profits exception). The Final Regulations also retain the exception from the proposed regulations for debt between members of a consolidated group. This Client Update focuses on aspects of the Final Regulations that are particularly relevant for the insurance industry.

### REGULATED INSURANCE COMPANY EXCEPTION

The Final Regulations provide a new exception to the scope of the proposed regulations that will be helpful for insurance groups. Under this exception, debt issued by certain regulated insurance companies is exempt from the application of the equity recharacterization rules, and such debt instruments are only subject to the documentation requirements. The rationale for this exception is that

regulated insurance companies' ability to issue debt is already restricted by their state regulators.

In order to qualify as a "regulated insurance company," a company must be:

- subject to Subchapter L;
- domiciled or organized in a state or the District of Columbia;
- licensed or regulated by one or more states or the District of Columbia; and
- engaged in regular issuances of (or subject to ongoing liability with respect to) insurance, reinsurance or annuity contracts with persons other than related persons.

This definition intentionally excludes section 953(d) companies, captive insurance and reinsurance companies and other non-insurance members of insurance company groups (*e.g.*, holding companies and service companies), all of which the Treasury believes are not subject to the same level of regulation and oversight as regulated insurance companies. As a result, debt issued by any of these excluded companies to related parties may be treated as equity under the equity recharacterizations rules, unless an exception applies. For example, the equity recharacterizations rules would apply to debt that is issued by a member of a U.S. group that is not a regulated insurance company either (i) to another U.S. member of the "Expanded Group" of related entities, if the two companies are not part of the same U.S. federal consolidated tax group (for example, because the group does not file as a life-nonlife consolidated group), or (ii) to a related foreign entity in the Expanded Group.

## FOREIGN CORPORATION EXCEPTION

The Final Regulations do not currently apply to debt issued by foreign corporations. As a result, the burden imposed on multinational groups that lend to foreign members, either from U.S. members or in foreign-to-foreign transactions, will be significantly reduced. The Treasury and the IRS will, however, continue to consider whether to issue regulations in the future that cover debt issued by foreign corporations. Note that this exception does not apply to section 953(d) companies, which are treated as U.S. corporations for U.S. federal tax purposes.

## OTHER GUIDANCE RELATING TO INSURANCE ARRANGEMENTS

Under the Final Regulations, regulated insurance companies generally will be subject to the documentation rules when debt is issued to related parties outside of the U.S. federal consolidated group. However, the Final Regulations provide a

helpful rule that extends the time period for all companies that are required to satisfy the documentation requirements to the deadline for filing the issuer's U.S. federal income tax return for the year in question (including extensions). This rule should allow issuers and lenders to review debt issuances at the end of each year and address any unintentional documentation failures.

The Final Regulations provide an exception from the general documentation requirements for surplus notes issued by regulated insurance companies if it is expected at the time of issuance that the surplus note will be paid in accordance with its terms and proper documentation is produced and maintained to support such expectation. This exception addresses concerns that a surplus note could never satisfy the general documentation requirements because the issuer of a surplus note does not have an unconditional obligation to pay a sum certain.

While the Final Regulations do not provide any specific rules applicable to insurance and reinsurance agreements, the Preamble states that Treasury and the IRS believe that reinsurance and funds-withheld reinsurance arrangements are not subject to the documentation requirements because such arrangements are not debt in form and are typically governed by the terms of a reinsurance contract. However, the Treasury and the IRS did not provide a specific exception for funds-withheld reinsurance arrangements from the equity recharacterizations rules. Instead, the Preamble notes only that insurance contracts and reinsurance contracts generally would not be subject to these rules because such contracts are not ordinarily treated as debt instruments. The Final Regulations therefore leave open the possibility that, in certain circumstances, the IRS might seek to assert that a funds-withheld reinsurance arrangement should be deemed to include a debt instrument that may be recharacterized as equity under the Final Regulations. We believe the IRS would face challenges in taking this approach because of the absence of an actual debt instrument or any unconditional obligation to pay a sum certain at one or more fixed dates.

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Please do not hesitate to contact us with any questions.