



# TaxNewsFlash

## United States

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### **Section 385 final regulations: Initial reaction to insurance-specific provisions**

The Treasury Department and IRS late yesterday released final and temporary section 385 regulations ("Final 385 Regulations") addressing the treatment of related party debt for U.S. tax purposes. These regulations had been proposed on April 4, 2016 (Proposed 385 Regulations). The following discussion contains a high-level summary of the insurance tax aspects of the Final 385 Regulations based upon an initial review of the new rules.

As with the Proposed 385 Regulations, the final version contains four separate sections:

- Reg. section 1.385-1 (providing general definitions and rules)
- Reg. section 1.385-2 (the "Documentation Rules")
- Reg. section 1.385-3 (the "Recast Rules")
- Reg. section 1.385-4 (the "U.S. Consolidated Group Rules")

Certain matters within the rules are reserved.

The insurance industry has generally raised several concerns specific to the industry. These concerns and responses are outlined below.

#### **Applicability Prop. Reg. section 1.385-3 to insurance companies**

The industry raised several concerns regarding the applicability of the "Recast Rules" of Proposed 385 Regulations to insurance companies. The Final 385 Regulations address this concern by including a broad exemption for certain regulated entities from the Recast Rules. Specifically, 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 instruments. Since regulated insurance companies, similar to regulated financial companies, are subject to risk-based capital requirements and other regulation, Treasury and the IRS have determined that such regulation mitigates the risk that insurance companies would engage in the types of transactions addressed by the Final 385 Regulations. As a result, the Final 385 Regulations provide that a covered debt instrument does not include a debt instrument issued by a regulated insurance company.

A regulated insurance company is defined as a covered member that is: (1) subject to tax under subchapter L of chapter 1 of the Code; (2) domiciled or organized under the laws of a state or the District of Columbia; (3) 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 (4) 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)).

The last prong of the definition of “regulated insurance company” is intended to have the effect of not including within the exclusion certain captive insurance and reinsurance captive companies. In general, covered debt instruments issued by such captive entities are not excluded under the Final 385 Regulations because captive insurers are not subject to risk-based capital requirements or regulation and oversight to the same degree as other insurance and reinsurance companies.

The effective date for the Recast Rule was largely retained, and thus applies to transactions occurring and debt issued on or after April 4, 2016. There is also a complicated “final transition period” that generally exempts debt from the Recast Rules if it is settled within 90 days of the publication of the Final Regulations (estimated to occur on October 21). Any debt that would have been recast between April 4, 2016 and the end of the final transition period is subject to recast upon the end of the final transition period.

## **Reinsurance arrangements**

The insurance industry requested that the regulations clarify that obligations arising in the ordinary course of business under reinsurance arrangements, including funds withheld reinsurance arrangements, are outside the scope of the section 385 regulations and should not be covered “Expanded Group Interests” (as defined in the Proposed Regulations).

The preamble and the Final 385 Regulations address this comment. The Final 385 Regulations only apply to interests that would, but for the application of Reg. section 1.385-3, be treated as debt instruments as defined in section 1275(a) and Reg. section 1.1275-1(d). As a result, 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 section 1275(a) and Reg. section 1.1275-1(d); and therefore, the preamble to the Final 385 Regulations concludes that there is

no need for specific guidance. As such, these agreements are not covered Expanded Group Interests under the Final 385 Regulations.

## **Surplus notes**

The insurance industry requested clarification on the “Documentation Rules” with respect to surplus notes. Specifically, the industry requested guidance that the necessity of regulatory approval for principal and interest payments not be an impediment to satisfying the Documentation Rules under the Proposed 385 Regulations.

To address this situation, the Final 385 Regulations provide an exception from the Documentation Rules for certain instruments issued by an excepted regulated financial company or a regulated insurance company, as those terms are defined in Reg. section 1.385-3(g). An Expanded Group Interest issued by an excepted regulated financial company is considered to meet the Documentation Rules as long as it contains terms required by a regulator of that issuer in order for it to satisfy regulatory capital or similar rules that govern resolution or orderly liquidation. An Expanded Group Interest issued by a regulated insurance company issuer is also considered to meet the Documentation Rules even if the instrument requires the issuer to receive approval or consent of an insurance regulatory authority before making payments of principal or interest on the Expanded Group Interest. In both cases, the Final 385 Regulations require that the parties expect at the time of issuance that the Expanded Group Interest 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.

## **Five-year rule for life companies**

Under the Proposed 385 Regulations, all members of a consolidated group are treated as a single corporation. The insurance industry requested that this rule be expanded to include certain life companies that are excluded from the consolidated group by reason of section 1504(b)(2).

Treasury and the IRS declined to include a special rule related to section 1504(c) (2) in the Final 385 Regulations. Treasury and the IRS recognized that that, 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. Treasury and the IRS concluded that, in this context, a consolidated group and its recently-acquired life insurance subsidiaries are not materially different from two separate consolidated groups are part of the same expanded group, and that no special rule is justified. However, the exception from the Recast Rules for debt issued by certain insurance companies mitigates some of the impact of Final 385 Regulations’ failure to incorporate an expanded consolidated group definition.

## Documentation Rules

There were numerous comments regarding the timing requirement within the Documentation Rules.

The Final 385 Regulations retain the proposed “relevant date” concept for the due date of documentation. In a crucial change, however, the substantive documentation now must only be completed by the due date for filing (including extensions) the tax return for the taxable year that includes the debt issuance or creditor event. This is a significant improvement over the prior 30-day timeline in the Proposed 385 Regulations.

This change will provide companies significantly more time to satisfy the Documentation Rules. Furthermore, the delay in effective date for the final Documentation Rules—to debt issued on or after January 1, 2018—provides a helpful transition period for companies to develop the necessary systems and agreements to comply going forward. Thus, for calendar-year taxpayers that file an automatic return extension, their first round of documentation materials will not be technically “due” until late 2019.

## KPMG observation

The proposed rules have been characterized as one of the most significant and potentially burdensome set of changes in the U.S. tax system in decades. After much speculation and concern, the final product reflects a significant effort by Treasury and the IRS to limit the scope and burden of the 385 Regulations, particularly for U.S. multinationals. More specifically, the Final 385 Regulations reflect many of the comments submitted by the insurance industry. The Final 385 Regulations contain many new terms and concepts that bear further close scrutiny, and they will be addressed in subsequent reports.

Read KPMG’s initial impressions about the regulations in [\*\*TaxNewsFlash-United States\*\*](#)

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