



To: The Honorable Mark J. Mazur  
Assistant Secretary (Tax Policy)  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Date: 7 July 2016

Subject: Comments on the Treatment of Insurance Companies and Insurance and Reinsurance Contracts under Internal Revenue Code Section 385 Proposed Regulations

Dear Mr. Secretary,

The Global Federation of Insurance Associations (GFIA) is writing to provide comments on the proposed regulations (REG-108060-15) under section 385 of the Internal Revenue Code<sup>1</sup> (“Proposed Regulations”)<sup>2</sup> to highlight the issues the Proposed Regulations present for the global insurance industry.

The global insurance industry shares the general concerns regarding the Proposed Regulations expressed thus far by corporations in other business sectors, and their representatives. Our comments in this letter are limited to insurance-specific issues, in particular in the cross-border context, and include recommendations for the treatment of insurance and reinsurance contracts conducted by members of an expanded group as defined in Prop. Treas. Reg. §1.385-1(b)(3). GFIA would ask you to also give due consideration to comments submitted by its member associations, the American Council of Life Insurers and the Reinsurance Association of America. We offer recommended solutions to address transactions that, although routine for our industry, require unique treatment so that insurers may continue to operate within the existing rigorous regulatory framework without undue and unnecessary disruption.

### **Summary of Recommendations**

We request that final regulations include rules to:

- expressly exclude insurance and reinsurance contracts from the scope of the Proposed Regulations as payments made in the ordinary course of the insurance business;
- recognize that the necessity of regulatory approval does not otherwise affect the insurance company’s unconditional and legally binding obligation to pay amounts owed, or affect the creditor’s rights, under debt instruments such as surplus notes;

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<sup>1</sup> Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, amended.

<sup>2</sup> On April 4, 2016, the IRS and Treasury issued Proposed Regulations (“the Proposed Regulations”) under authority granted in section 385 of the Internal Revenue Code (“Code”) that would, in certain circumstances, treat related-party debt as equity for U.S. tax purposes.

- provide a look-back rule for mergers and acquisitions of insurance companies so that any related party debt within 36 months pre and post such transactions is treated as related to the merger or acquisition for purposes of the Proposed Regulations;
- allow a portion of prior years' Earnings & Profit (E&P) in lieu of the current E&P exception. If the current E&P exception is retained in the final regulation, insurers should be allowed to make a distribution within the time frame prescribed by state regulation, i.e., during the following year, and still consider the distribution as qualified under the current year E&P exception.

### **Insurance and Reinsurance**

One aspect of insurers' unique business model is due to the extensive regulation insurers operate under; another stems from the complex nature of a business model which undertakes and manages risk.

As regulated financial institutions, insurance companies are subject to rigorous capital requirements imposed by domestic and global insurance regulators.<sup>3</sup> Insurance companies are therefore subject to strict regulation that limits the amount of inter-company debt. Any monies borrowed by an insurance company need to meet strict investment limitations that necessarily limit the benefit of any leveraging. In addition, it is important that insurers achieve and retain high financial ratings from rating agencies, which further constrains the use of related-party debt. For these reasons, an insurance company's ability either to leverage itself with related-party debt or to hold related-party debt are subject to substantial regulatory and sound business limitations. As a result, opportunities for an insurance company to engage in the type of financial leveraging with which the Proposed Regulations are concerned are substantially limited.

One consequence of the substantial regulatory limitations placed on the issuance of debt by life insurance companies is that mergers and acquisitions must be structured carefully to avoid an inappropriate level of debt at the insurance company level. Thus what is ultimately third party debt financing of such contracts may require debt to be placed temporarily<sup>4</sup> with a related party to facilitate the acquisition or merger until such time as the contract is completed and necessary regulatory approvals are secured for the newly acquired or merged company.

In the following paragraphs, we describe the issues for insurance companies and how the proposed regulations should be further refined to reflect contracts that are unique to the insurance industry so that unnecessary additional burdens are not placed on routine contracts entered into by related parties.

The Proposed regulations apply to members of an expanded group defined in Prop. Treas. Reg.

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<sup>3</sup> For example, Solvency II, a European Union (EU) Directive, introduced a harmonised EU-wide insurance regulatory regime in all EU Member States effective 1 January 2016.

<sup>4</sup> The winding up and down process is a lengthy one, and it can take some time for the debt raised to find its way back to the life insurance company when the transaction is completed.

§1.385-1(b)(3) generally, a parent and subsidiary entities that are, directly or indirectly, at least 80% owned by vote or value. Members of a consolidated group as defined in Treas. Reg. §1.1502-1(h) are treated as one corporation. Several issues stem from the definition of consolidated group provided in the Proposed Regulations which affect foreign owned groups of U.S. companies of our members. We would refer you to the views expressed in the June 17<sup>th</sup> letter by the American Council of Life Insurers for more details on this point.

Non-U.S. members of parents and subsidiary groups cannot ever join in the filing of a consolidated group return, thus all contracts between a non-U.S. and U.S. members of 80% owned groups are subject to the Proposed Regulations. Even if the Proposed Regulations are revised to include an “ineligible” life insurance company in a consolidated group for purposes of the regulations, routine insurance and reinsurance contracts between members of an expanded group could nonetheless become subjected to these onerous rules unnecessarily. It is for this reason that ***we request that insurance and reinsurance contracts be excluded from the definition of debt instrument under Prop. Treas. Reg. §1.385-3(f)(3)*** since, in addition to the extensive domestic and global regulatory framework, Subchapter L of the Code provides extensive rules for the U.S. Federal tax treatment for such contracts.

#### **Funds Withheld Coinsurance Contracts**

Reinsurance is the sharing of direct insurance risk with other insurers, and so is sometimes thought of as insurance for insurance companies. In the ordinary course of business, insurance companies engage in reinsurance contracts with both related and unrelated parties for a wide variety of non-tax business reasons, including:

- Capital relief;
- Asset/liability duration mismatches;
- Diversification to address concentration of risk, including geographical concentration;
- Expanding market share while not exceeding risk limits;
- Enabling a company to issue a policy on a single life in excess of its retention limit;
- Economies of scale in policy administration costs; and
- Withdrawing from a line of business.

One form of reinsurance undertaken by life insurance companies is known as indemnity reinsurance or coinsurance. Under such contracts, the direct writer (ceding company) remains directly liable to the contract owner, but the reinsurer shares in the risk. In coinsurance, the reinsurer establishes reserves for its share of the policy liabilities. The ceding company may transfer assets to the reinsurer to support the reinsurer’s reserve obligations, or the parties may enter into a “funds withheld” arrangement whereby the ceding company retains control of the assets.

A ceding company may prefer funds withheld to an actual asset transfer because this allows the ceding company to maintain investment control over the assets. Such a structure provides security for payments due from the reinsurer under the reinsurance agreement without the need for establishing trusts for the benefit of the ceding company.

Funds withheld transactions also occur in the non-life context. Ordinarily, if an insurance company purchases reinsurance, the ceding company will transfer a specified risk to the reinsurer and reduce its reserve liabilities by an amount equivalent to the reserves related to the risk transferred. In funds withheld reinsurance, the ceding company pays a premium to the assuming reinsurer, but retains sufficient funds to cover the reserve liabilities associated with the risk transferred. Funds remaining in the account will be returned to the reinsurer after the expiration of the policy term and all claims associated with the policy have been resolved.

The funds withheld in such reinsurance arrangements refer to the “[a]ssets that would normally be paid over to a reinsurer but are withheld by the ceding company to permit statutory credit for non-admitted reinsurance, to reduce a potential credit risk or to retain control over investments”.<sup>5</sup> The control the ceding company exercises over the investments is akin to that of a custodian. Amounts payable under such contracts are not payments made pursuant to debt instruments, but amounts that must be paid to the reinsurer pursuant to the terms of the reinsurance contract. Prop. Treas. Reg. §1.385-3(f)(3) defines a “debt instrument” as “an interest that would . . . be treated as a debt instrument as defined in section 1275(a) and §1.1275-1(d)”. Treas. Reg. §1.1275-1(d) defines “debt instrument” as “any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law”. This broad definition notwithstanding, payables from the ceding company to the reinsurer do not represent unconditional promises to pay a sum certain. Moreover, the contractual promise has no fixed maturity date, hence lacking the necessary features of indebtedness.

Moreover, funds withheld reinsurance does not create additional leverage in the ceding company because the obligation to the reinsurer arises from the ceding company’s retention of investment assets that otherwise would have been transferred to the reinsurer and the ceding company is required to continue to hold those assets in support of the reinsurance contract. As a result, the assets cannot be distributed.

***We request the proposed rules be amended to provide for an exclusion for contracts entered into in the ordinary course of insurance and reinsurance business, including funds withheld reinsurance contracts, from the application of the Proposed Regulations.***

Finally, while we believe that payment streams under funds withheld reinsurance contracts do not constitute indebtedness in substance or in form, there is concern that the documentation requirements of the proposed regulations could be broadened to cover such agreements inappropriately. The documentation rules apply to “applicable instruments”, which Prop. Treas. Reg. §1.385-2(a)(4)(i) defines as “any interest issued or deemed issued that is in form a debt instrument”. Treasury and the IRS have asked whether documentation for interests not in the form of indebtedness should be addressed by the proposed documentation rules. **We see no reason why the scope of these already overly extensive rules should be broadened, particularly since the rules incorporate**

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<sup>5</sup> Tiller & Fagerberg Tiller, LIFE, HEALTH & ANNUITY REINSURANCE, 3d ed. 2005.

## **principles of Federal income tax law on characterization of instruments as indebtedness.**

### **Surplus Notes**

Section 1.385-2 of the Proposed Regulations includes documentation and maintenance requirements which must include information that establishes that:

- the obligor has an unconditional obligation to pay a sum certain;
- the holder has rights of a creditor to enforce the obligation;
- there is a reasonable expectation that the obligor will be able to repay the debt; and
- the obligor and creditor exhibit and record actions evidencing a debtor-creditor relationship, such as making and receiving scheduled principal and interest payments or that the holder takes action to enforce its rights in the event of default.

If the documentation requirements are not satisfied within the times allotted by the proposed rules, then the instrument will be treated as stock, rather than debt. Meeting the documentation requirements however does not provide a safe harbor that the instruments so documented are treated as debt under the Proposed Regulations.

As noted above, insurers are subject to extensive and multi-layered capital and financial regulations, which in addition to having the effect of limiting the amount of debt an insurance company can issue or hold, enforce such ability by requiring regulatory approval before payments may be made with respect to debt issued. ***We request the Proposed Regulations be modified to recognize that the necessity of regulatory approval does not otherwise affect the insurance company's unconditional and legally binding obligation to pay amounts owed, or affect the creditor's rights, under debt instruments such as surplus notes.***

### **Mergers and Acquisitions**

Due to the regulatory limitations placed on accrual of debt by life insurance companies, mergers and acquisitions must be structured carefully to avoid an inappropriate level of debt at the insurance company level. Thus debt financing of such contracts requires third-party debt to be placed temporarily with a related party to facilitate the acquisition or merger until such time as the contract is completed and necessary regulatory approvals are secured for the newly acquired or merged company.

The Per Se rule in Treas. Prop. Reg. §1.385-3 would deem any intercompany debt instruments issued in the expanded group of life insurance companies as issued with the principal purpose if issued during the period beginning 36 months before and ending 36 months after the date of the relevant distribution or acquisition. ***The Proposed Regulations should be amended to provide a look-back rule for mergers and acquisitions of insurance companies so that any related party debt within 36 months pre and post such transactions, is treated as related to the merger or acquisition for purposes of the Proposed Regulations.***

### **Exception Provided for Current Year Earnings and Profits**

Under Prop. Reg. §1.385-3(c)(1), a member of an expanded affiliated group will not trigger the recast rule or the funding rule of Prop. Reg. §1.385-3 if the aggregate amount of distributions or acquisitions

made during the year are equal to the member's current year earnings and profits ("E&P").

As a practical matter, it will be difficult --- probably impossible --- for many insurance and reinsurance companies to use the exception, since they are unable to estimate their current year E&P with a high degree of confidence. The problem is particularly acute for non-life insurers and reinsurers that cover catastrophic events, such as hurricanes, flooding, firestorms or earthquakes, which may occur in the last quarter of the year. Major catastrophes may cause a dramatic swing in a company's E&P, and even change a profit to a loss. While life insurance results are ordinarily less subject to the radical swings sometimes seen in the general insurance business, life insurers' financial results may be subject to unexpected drops in investment results, and may see unexpected changes in investment returns that change their E&P for the year. For both life and general insurers, a reasonable time after year-end is required to collect data from policyholders and claimants needed to estimate a year's E&P.

In addition, U.S. subsidiaries of non-U.S. insurers are subject to regulatory constraints on their distributions to affiliates, just like other U.S. insurance companies. Under state regulatory provisions, to pay a dividend greater than the lesser of 10% of the insurer's prior year's policyholder surplus or its net income for the preceding calendar year, a U.S. insurer must give the state insurance commissioner no less than 30 days' notice during which the commissioner may disapprove the distribution. Faced with these regulatory constraints, U.S. insurers generally wait until the following year to pay a dividend related to a current year's E&P.

Given the difficulty in forecasting current year's E&P and the constraints imposed by state insurance regulators, most insurance companies will be unable to take advantage of the exception for current year's E&P. ***GFIA understands that other commenters on the proposed regulations will request that some amount of prior years' E&P be allowed in lieu of the current E&P exception. GFIA agrees with this approach. However, if the current E&P exception is retained in the final regulation, the final regulation should provide an alternative that would allow insurance companies to make the distribution within the time frame prescribed by state regulation, i.e., during the following year, and still consider the distribution as qualified under the current year E&P exception.***

#### **GFIA contact**

Peggy McFarland, chair GFIA Taxation Working Group, [pmcfarland@clhia.ca](mailto:pmcfarland@clhia.ca)

#### **About GFIA**

Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.