KPMG report: “BEAT” proposed regulations, provisions applicable to insurance companies

The U.S. Treasury Department and IRS on December 13, 2018, released proposed regulations (REG 104259-18) under section 59A, which was enacted as part of the U.S. tax law referred to as the “Tax Cuts and Jobs Act” (Pub. L. No. 115-97).

Section 59A

New section 59A imposes an addition to tax (the “base erosion and anti-abuse tax” or “BEAT”) that targets certain deductions or similar tax benefits (“base erosion tax benefits”) attributable to “base erosion payments” made to foreign related parties by certain “applicable taxpayers.”

An applicable taxpayer is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that is a member of a group of related corporations (an aggregate group) that has average annual gross receipts of at least $500 million for the three-tax-year period ending with the preceding tax year, and has a “base erosion percentage” (generally the ratio of base erosion tax benefits over the aggregate deductions (with limited exceptions) allowable to the taxpayer during the tax year) in excess of 3%. The base erosion percentage threshold is dropped to 2% in the case of an aggregate group that includes an affiliated group containing a bank or registered securities dealer.

- Read KPMG report: Analysis and observations about “BEAT” proposed regulations [PDF 325 KB] that summarize and highlight measures in the proposed regulations.

- Read the proposed regulations [PDF 860 KB] (183 pages)

The following discussion highlights and provides observations about certain key provisions that apply specifically to insurance companies.
Treatment of an affiliated group that includes a bank or registered securities dealer

Consistent with the Internal Revenue Code, for an aggregate group that includes an affiliated group containing a bank or a registered securities dealer (i.e., broker-dealer), the proposed regulations lower the threshold base erosion percentage for purposes of determining whether a taxpayer is an applicable taxpayer from 3% to 2%, and increases the BEAT tax rate for members of the affiliated group by one percentage point. However, the regulations provide that the lower 2% threshold will not apply for a tax year if the total gross receipts of the aggregate group that are attributable to the bank or registered securities dealer represent less than 2% of the total gross receipts of the aggregate group.

This a welcome provision for insurance groups, which often include broker-dealers with limited activity and revenue that is not a significant percentage of the gross receipts of the aggregate group. Less welcome is an anti-abuse rule which provides that transactions or arrangements among related parties with a principal purpose of avoiding rules applicable to banks or registered securities dealers are disregarded. This anti-abuse rule could potentially be applied to companies that have moved to deconsolidate their broker-dealers in order to avoid the lower 2% threshold or to benefit from the lower BEAT tax rate.

Treatment of claim losses

The preamble acknowledges that for purposes other than section 59A, the Code describes payments of claims for losses incurred made by non-life insurance companies as both reductions of gross receipts and as deductions against gross income. The question of whether a non-life insurance company is free to treat the payments as one or the other for purposes of characterizing the payments as base erosion payments under section 59A has been widely debated.

While requesting comments on the appropriate treatment of the claims payments in general, but failing to insist that claims payments be treated as deductions, the proposed regulations and preamble can be read as signaling recognition (at least pending future guidance) of the position that payments of non-life insurance claims to related foreign persons are not base erosion payments. Presumably, a company will be required to apply its treatment of claims payments consistently for the qualification fraction and the calculation of modified taxable income. The preamble also requests comments on whether life insurance companies should obtain the same treatment of claims payments as non-life insurance companies.

Offsetting reinsurance payments

Another question that has been widely discussed is the calculation of the BEAT with respect to reinsurance transactions that have offsetting payments between the ceding company and the reinsurance company. While the proposed regulations specify that
taxpayers may not net receipts and payments for purposes of the BEAT in a manner different than allowed under general tax rules (even when the parties have a right of setoff against each other and the amounts are settled on a net basis), the preamble requests that taxpayers comment on whether there should be a distinction between reinsurance contracts with netting and other commercial contracts.

This request seems to be referring to modified co-insurance and funds withheld insurance arrangements, but could be meant more broadly.

**Group members with different tax years**

An aggregate group that includes more than one U.S. consolidated group, or that includes stand-alone entities, may in some cases have companies that are on different tax years. The proposed regulations require aggregate group members with different tax years to determine gross receipts and the base erosion percentage on an aggregate basis (i.e., taking into account the results of all members of the aggregate group) but with respect to each entity's individual tax year. This means that gross receipts and base erosion percentage would have to be determined for all entities in the group on both a calendar year and a fiscal year basis. As a result, two members of the same aggregate group could have different gross receipts and base erosion percentages. Taxpayers are allowed to use a reasonable method to determine the gross receipts, numerator and denominator numbers for members of the aggregate group that do not have the same tax year.

Depending on what methods are considered reasonable, this approach might be practicable for non-insurance companies, it may be burdensome for insurance companies, particularly relating to reserve calculations.

**Treatment of base erosion payments to U.S. branch of a foreign entity**

As expected, the proposed regulations exclude from treatment as base erosion payments amounts paid to a foreign related party that are subject to U.S. income taxation as effectively connected income (ECI) of a U.S. branch, or income attributable to a permanent establishment under an applicable U.S. tax treaty. However, when the income of the foreign corporation that is allocated to the U.S. branch is computed under the business profits article of the treaty on the basis of functions performed, assets used, and risks assumed, and not on the basis of U.S. expense allocation principles, the proposed regulations would treat any deductions attributable to amounts paid or deemed paid by the permanent establishment to its home office or another branch of the same entity as fully subject to BEAT to the extent that they would otherwise qualify as BEAT payments.

Any foreign corporation with a U.S. branch will need to examine its methodology for allocation of expenses to determine if the allocation gives rise to deemed base erosion payments.
Net operating loss rules

The proposed rules clarify the effect of net operating losses (NOLs) in computing modified taxable income (MTI).

First, the proposed rules provide that an NOL carryover deduction cannot reduce taxable income below zero for determining the starting point for computing MTI. That is, a deduction for a pre-2018 NOL (which is not subject to the new limitation of 80% of taxable income) would be taken into account for purposes of the MTI starting point only to the extent of the amount of taxable income prior to the NOL deduction, with the result that an NOL carryover cannot cause MTI to become negative. Similarly, to compute the add-back for the NOL, the base erosion percentage of the NOL would be applied to the same amount that was used to reduce taxable income in computing the MTI starting point. Accordingly, the add-back would be determined by taking into account the 80% of taxable income limitation for post-2017 NOLs under new section 172(a) and the “no negatives” limitation described above.

The preamble discussion, the proposed regulations, and examples in the proposed regulations emphasize the impact of loss carryforward on the BEAT calculation of MTI. However, these provisions also apply to the carryback of non-life insurance companies. Consequently, under the proposed regulations, whenever a property and casualty company has a loss carryback, the insurer recalculates its BEAT for the carryback year to account for the impact of the loss carryback. This will add complexity to the insurer’s carryback calculations.

Calculation of MTI for a life / non-life consolidated group

The proposed regulations clarify that MTI and base erosion minimum tax amount are determined for a consolidated group as if it were a single taxpayer. The proposed regulations also clarify that taxpayers with net losses in the current year have negative taxable income as a starting point for calculating MTI. This is in contrast with the treatment under the proposed regulations of net operating loss carryovers discussed above, which for purposes of MTI, cannot reduce taxable income to below zero.

Questions remain, however, regarding how current year losses apply in life / non-life consolidated groups. In calculating life / non-life consolidated taxable income, non-life subgroup net losses can generally offset only life subgroup income to the extent of the lesser of 35% of the non-life losses or 35% of the life subgroup income. In addition, the regulations governing life / non-life consolidation state that each subgroup’s taxable income cannot be reduced below zero by the subgroup’s current-year losses. Thus, even when the non-life subgroup has current year losses significantly in excess of income in the life subgroup, a strict “consolidated” approach would disadvantage life / non-life groups by calculating modified taxable income based on the consolidated taxable income of the group as a whole.

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