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KPMG report: "BEAT" final regulations, provisions applicable to insurance companies

The U.S. Treasury Department and IRS on December 2, 2019, released for publication in the Federal Register final regulations (T.D. 9885) and additional proposed regulations (REG-112607-19) under section 59A—the Code provision referred to as "BEAT" (the base erosion and anti-abuse tax) as enacted as part of the 2017 U.S. tax law (Pub. L. No. 115-97, date of enactment of December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act").

The following discussion highlights and provides observations about certain key provisions that apply specifically or may be relevant to insurance companies.

Documents and other KPMG reports

- Read **KPMG report: Initial impressions, final regulations and additional proposed regulations under section 59A ("BEAT")** [PDF 118 KB] (five pages) that highlight certain items and summarize the final regulations
- Read the **final regulations** [PDF 614 KB] (78 pages as published in the Federal Register on December 6, 2019) referred to in this report as the "final regulations"
- Read the **additional proposed regulations** [PDF 366 KB] (13 pages as published in the Federal Register on December 6, 2019) and referred to in this report as the "proposed regulations"
- Read **KPMG report: "BEAT" proposed regulations, provisions applicable to insurance companies** [PDF 52 KB] (five pages) summarizing the insurance-specific provisions in the 2018 proposed regulations

Background

Section 59A imposes an addition to the corporate income 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." Generally, under section 59A(d)(1), a base erosion payment means any amount paid or accrued by the taxpayer to a foreign related party for which a deduction is allowed. Section 59A(d)(3) provides that a base erosion payment also includes any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments that are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A) for life and nonlife companies, respectively.

The preamble to the original proposed regulations, REG-104259-18 (December 21, 2018), requested comments regarding several issues relating to insurance companies. Specifically, comments were requested with respect to: (1) whether claims payments for losses incurred and other deductible payments made by a domestic reinsurance company to a foreign related insurance company are base erosion payments within the scope of section 59A(d)(1); and (2) certain reinsurance agreements and other commercial agreements with reciprocal payments that are settled on a net basis.

Reinsurance claims payments to a related foreign insurance company

The original proposed regulations did not provide specific rules for payments made by a domestic reinsurance company to a related foreign insurance company. For a life insurance company, payments for claims or losses incurred are deductible pursuant to section 805(a)(1); therefore, these payments are potentially within the scope of section 59A(d)(1). With respect to nonlife insurance companies, however, certain claims payments for losses incurred may be treated as reductions in gross income under section 832(b)(3), rather than deductions under section 832(c). Since reductions in gross income under section 832(b)(3) are not included within the scope of section 59A(d)(3), these payments are prima facie not base erosion tax payments or benefits under section 59A. As noted in the request for comments, this would have created a disparity of treatment of similar payments between life and nonlife insurance companies.

In response, comments made to Treasury and the IRS generally requested that the final regulations provide an exception to the term "base erosion payment" for claims payments made by a domestic reinsurance company to a related foreign insurance company. Comments also addressed how an exception for claims payments should affect the base erosion percentage calculation. For example, comments recommended that claims payments made to foreign related parties be excluded from the numerator, but claims payments made to others be included in the denominator. If all claims payments were eliminated from the denominator (which might be the case if they were treated as reductions in gross income), comments noted that a significant amount of business expenses would be removed from the base erosion percentage calculation.

In response to these comments, Reg. section 1.59A-3(b)(3)(ix) provides a specific exception for deductible amounts for losses incurred (as defined in section 832(b)(5)) and claims and benefits under section 805(a) ("claims payments") paid pursuant to reinsurance contracts that would otherwise be within the definition of section 59A(d)(1), to the extent that the amounts paid or accrued to the related foreign insurance company are properly allocable to amounts required to be paid by such company (or indirectly through another regulated foreign insurance company), pursuant to an insurance, annuity or reinsurance contract, to a person other than a related party. The final regulations also clarify that all claims payments are included in the denominator of the base erosion percentage, except to the extent excepted from the definition of a base erosion payment under Reg. section 1.59A-3(b)(3)(ix). This treatment in the denominator is consistent with the treatment of other excepted items addressed in the final regulations including qualified derivative payments, section 988 foreign exchange losses, and deductions for services eligible for the services cost method exception.

Netting with respect to insurance contracts

In general, the amount of any base erosion payment is determined on a gross basis, regardless of any contractual or legal right to make or receive payments on a net basis. The 2018 proposed regulations did not provide an exception to this general rule with respect to reinsurance agreements.

Several comments recommended that the final regulations permit netting with respect to reinsurance contracts to better reflect the economics of the transactions. One comment suggested that the final regulations permit netting with respect to a single economic transaction when the parties exchange net value in the form of a single payment, which would include many reinsurance transactions. Other comments identified specific types of reinsurance transactions for which netting should or should not be permitted. For quota share reinsurance arrangements, comments noted that the proposed regulations provide that the gross amount of reinsurance premium is a base erosion payment without considering any inbound payments such as reserve adjustments, ceding commissions, and claims payments. Other comments suggested that the amount of base erosion payments with respect to modified coinsurance ("modco") and funds withheld reinsurance be determined on a net basis (particularly when settlement is on a net basis) in the final regulations to be consistent with the norm of paying tax on a net basis.

The final regulations do not adopt these recommendations that payments made under a reinsurance contract be netted for purposes of determining the amount of a base erosion payment, unless netting would otherwise be permitted for U.S. federal income tax purposes. Because amounts of income and deduction are generally determined on a gross basis under the Code, and unless a rule permits netting (so that there is no deduction or the deduction is a reduced amount, as opposed to a deduction offset by an item of income), no netting is permitted. For example, whether payments under particular types of reinsurance contracts (for example, modco) may be netted for purposes of section 59A is determined based on the existing rules in the Code and regulations regarding netting. The Subchapter L provisions cited in section 59A(d)(3) (section 803(a)(1)(B) for life insurance companies and section 832(b)(4)(A) for nonlife insurance companies) do not provide for netting of ceding commissions, claims payments or other expenses against premiums.

Of additional note, when discussing transactions that provide for net payments generally, Reg. section 1.59A-3(b)(2)(iii) uses a reinsurance example, specifically stating that "any premium or other consideration paid or accrued by a taxpayer to a foreign related party for any reinsurance payments is not reduced by or netted against other amounts owed to the taxpayer from the foreign related party or by reserve adjustments or other returns."[1]

Life-nonlife consolidated groups

In addition to the above issues, some comments raised concerns that the proposed section 59A regulations—including the Prop. Reg. section 1.1502-59A with respect to consolidated groups—may be incompatible with the rules and framework of Reg. section 1.1502-47 for life-nonlife consolidated groups. The Treasury Department and IRS are analyzing these concerns and expect to address the issues in future proposed regulations, and thus reserve on this matter in the final regulations.

KPMG observation

The final regulations are generally consistent with the 2018 proposed regulations. Although the Treasury and IRS did not accept the vast majority of comments made on the regulations, the final regulations adopted a number of provisions that will be helpful to insurance companies. In addition to the special rule for claims payments (described above), which benefits both life and non-life companies by reducing the payments that are treated as base erosion payments without increasing the likelihood that the base erosion percentage threshold will be exceeded, a number of changes were made that insurance companies need to consider when reviewing their potential BEAT liability. Among other things, the final regulations:

- Changed the treatment of foreign currency losses, making it less likely that a company with such losses will exceed the base erosion percentage threshold

[1] The regulations also note that a derivative contract does not include any insurance, annuity or endowment contract issued by an insurance company subject to Subchapter L of the Code.

- Clarify that alternative minimum tax credits are treated as overpayments of tax and do not reduce regular taxable income, and so will not create the potential for additional BEAT liability
- Provide that section 15 does not apply to create a blended BEAT rate of tax for tax years beginning in calendar year 2018 and ending in 2019

Treasury and the IRS also issued potentially helpful rules in the set of "additional proposed" BEAT regulations as released simultaneously with the final BEAT regulations and on which taxpayers may rely, including an election to waive a deduction for expenses.

The regulations appear to foreclose netting reinsurance payments against gross premiums for purposes of 59A with respect to current industry standard coinsurance, funds withheld, and modco contracts. The regulations also do not allow for payments under an insurance, annuity or endowment contract issued by an insurance company to be exempted from BEAT as being a qualified derivative payment. It remains to be seen if other types of reinsurance contracts that provide for a net economic result can be developed that: (1) achieve a company's risk transfer goals: (2) meet regulatory risk transfer and reserve credit requirements; (3) are not subject to gross accounting treatment under NAIC statutory accounting principles; and (4) continue to qualify as an insurance contract for Subchapter L of the Code.

Taxpayers can refer to and consult KPMG's report on the final regulations and additional proposed regulations under section 59A (see above).

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