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KPMG report: Treasury responds to insurance comments in proposed and final regulations on foreign tax credit

The IRS on September 29, 2020, released a version of final regulations (T.D. 9922) providing guidance relating to the allocation and apportionment of creditable foreign taxes and deductions (including certain deductions for life insurance companies) and the definition of financial services income among other topics.

These regulations finalize regulations that were proposed in December 2019 ("the 2019 FTC proposed regulations") to provide guidance for the allocation and apportionment of deductions and creditable foreign taxes and the definition of financial services income under sections 861, 904, 905, 954 and 960, among other provisions. Read the **final regulations** [PDF 1.07 MB] (287 pages).

Simultaneously, the IRS on September 29, 2020, also issued a version of proposed regulations (REG-101657-20) that propose additional guidance relating to the foreign tax credit and related issues ("the 2020 FTC proposed regulations.") Read the **proposed regulations** [PDF 1.10 MB] (297 pages).

Read a KPMG report providing initial impressions about the final and proposed regulations: ***TaxNewsFlash***

This edition of *TaxNewsFlash* highlights some of the provisions that specifically focus on insurance companies.

Final regulations and Proposed Regulations

Treatment of section 818(f) reserve expenses for consolidated groups

Section 818(f)(1) provides that the deduction for life insurance reserves and certain other deductions ("section 818(f) expenses") are treated as items that cannot definitively be allocated to an item or class of gross income. As a result, when a life insurance company computes its foreign tax credit limitation, its section 818(f) expenses generally reduce its U.S.-source income and foreign-source income ratably.

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However, issues arise as to how to allocate and apportion section 818(f) expenses if the life insurance company is a member of an affiliated group of corporations (including both life and nonlife members) that join in filing a consolidated return.

In the preamble to the 2019 FTC proposed regulations, Treasury indicated that it was aware of at least five methods for allocating section 818(f) expenses in a life-nonlife consolidated group. In the 2019 FTC proposed regulations (Prop. Reg. section 1.861-14(h)(1)), Treasury proposed a separate company method. Under this method, the expenses are allocated solely among items of the life insurance company that has the reserves. Treasury believed this method is generally consistent with section 818(f) and with the separate company treatment of reserves under Reg. section 1.1502-13(e)(2). Under these regulations, direct insurance transactions between members of a consolidated group are accounted for by both members on a separate entity basis.

Nevertheless, Treasury expressed a concern that the separate company method could create opportunities for consolidated groups to use intercompany transactions to shift their section 818(f) expenses and achieve a more desirable foreign tax credit result. In the preamble to the 2019 FTC proposed regulations, Treasury requested comments on whether the life subgroup method more accurately reflects the relationship between section 818(f) expenses and the income producing activities of the life subgroup as a whole, and whether the life subgroup method is less susceptible to abuse because it might prevent a consolidated group from inflating its foreign tax limitation through intercompany transfers of assets, reinsurance transactions or transfers of section 818(f) expenses. Treasury also requested comments on whether an anti-abuse rule is appropriate to address concerns with the separate-company method, and regarding the appropriate application to neutralize the ancillary effects of separate-company computation of insurance reserves, such as the computation of limitations under section 904.

In response to its request, Treasury received several comment letters. One comment argued that the separate-company approach was inconsistent with the general rule in section 864(e)(6) that expenses other than interest that are not directly allocable or apportioned to any specific income-producing activity are allocated and apportioned as if all members of the affiliated group were a single corporation and that the separate-company approach opens the door for aggressive tax planning through intercompany transactions and that the subgroup method should be adopted.

Another comment argued that the separate-company approach was consistent with the fact that life insurance companies are regulated on their reserves, investable assets, and capital on an individual company basis. The comment recognized that a life subgroup approach may be appropriate in certain cases and suggested that the regulations provide a one-time election for taxpayers to elect either a separate-entity or life-subgroup approach. Such election would be revocable only with the consent of the Secretary. The comment recommended that the election be available for the first tax year ending after the final regulations are published in the Federal Register. The comment argued against a specific anti-abuse rule in the FTC regulations and pointed to section 845 which provides a general anti-abuse rule for reinsurance transactions.

Another comment suggested that, if the proposed regulations do not adopt an option to elect either the separate-entity method or the life-subgroup method, then the life subgroup method rather than the separate-entity method should be adopted.

Treasury agrees that there are merits and drawbacks to both the separate-company approach and the life-subgroup approach. The final regulations do not include a separate-company rule for section 818(f) expenses. Instead, Treasury is re-proposing regulations to address this issue. The 2020 FTC proposed regulations include a life-subgroup approach and a one-time election for taxpayers to choose the separate-company approach. A consolidated group's use of the separate-entity method constitutes a binding choice to use the method chosen for that year for all members of the group and all tax years thereafter. See Prop. Reg. section 1.861-14(h).

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KPMG observation

The proposed regulations largely follow the suggested approach in the comment letters. However, rather than a one-time election, an election that allows taxpayers to change between the separate-company election and the life subgroup approach with the permission of the IRS is more consistent with other elections in the Internal Revenue Code.

The one-time election is proposed to be made on a taxpayer's return "for its first taxable year to which this section applies." Given that "this section" is Reg. section 1.861-14, which generally applies to tax years beginning after December 31, 2019, the proposed rule could be read to require an election to be made for 2020 for a calendar year group, even though the rule providing for the election would not be effective until 2021 at the earliest. Presumably the deadline should be understood to refer to the first year to which the proposed section 818(f) expenses rule would apply, so as to not necessitate the filing of an amended return to make a one-time election.

Definition of financial services entity

Section 904(d)(2)(D) provides that financial series income is income received or accrued by a person "predominantly engaged in the active conduct of a banking, insurance, financing or similar business. Long-established regulations under section 904 provide that entities engaged in such a business are those that earn 80% or more of their gross income from financial services income, and also provide a list of the specific types of income that give rise to financial services income. The 2019 FTC proposed regulations would eliminate these definitions and instead define a foreign service entity ("FSE") by cross-referencing sections 954(h), 1297b)(2)(B), and 953(e). The rules under those Code sections are more general, and in particular do not provide a list of qualifying income. In addition, the cross reference would appear to result in the exclusion of certain types of previously qualifying income from the definition of financial services income.

Numerous insurance, banking, and financial service entities commented on, and raised concerns with, the proposed regulations. One comment noted that the proposed definition of FSE appears to result, in part, in investment income of foreign insurance companies to be treated as passive category income for foreign tax credit limitation purposes under section 904. The comment recommended that the definition of an FSE be expanded to include entities that: (1) if domestic, are subject to tax under subchapter L of the Code , or (2) if foreign and regulated under the insurance laws of the country in which they operate, would be subject to subchapter L if such entity were to be domestic.

Another comment noted that the current regulatory definitions of financial service income and financial services entity, and the special rule for affiliated groups which are predominantly engaged in an active financing business, are well understood by taxpayers and have operated as intended—i.e., to distinguish financial services income from passive category income for foreign tax credit limitation purposes. Accordingly, the comment argued that the proposed changes to the regulations under Reg. section 1.904-4(e) are unnecessary. In addition, the comment requested that the definition of financial services group include an affiliated group which derives more than 70% of the gross income from financial services business (including insurance businesses), rather than the more limited definition of the proposed regulations, which would define an FSE group as an affiliated group with more than 70% of its gross income derived from the active conduct of a lending or finance business as set out in section 954(h)(2)(B)(i).

One comment also suggested that final regulations expand the proposed definition of financial services income to include income currently described in Reg. section 1.904-4(e)(2)(i)(B). This would include income from providing services as an insurance underwriter and income from insurance brokerage or agency services. It appeared that this type of income would be excluded from "financial services income" under the definition set out in the proposed regulations.

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In the preamble to the 2020 FTC final regulations, Treasury determined that revisions to the FSE rules continue to be necessary in light of legislative and other regulatory changes. However, Treasury determined that changes to the FSE rules should be re-proposed to allow further comment.

The 2020 FTC proposed regulations retain the general approach of the existing Reg. section 1.904-4(e) of the final regulations by providing a numerical test whereby an entity is an FSE if more than a threshold percentage of its gross income is derived directly from active financing income, and the regulations continue to contain a list of the types of income that qualify as active financing income.

The proposed regulations, however, lower the threshold from 80% to 70%. The proposed regulations also provide that active financing income most generally be earned from customers or other counterparties that are not related parties.

The 2020 FTC proposed regulations have specific rules for insurance companies. Although Treasury recognizes that insurance companies hold passive investment assets to support their insurance obligations, Treasury has proposed limits on the amount of an insurance company's investment income that may be treated as active financing income when the insurance company holds substantially more investment assets and earns substantially more passive income than necessary to support its insurance business.

Specifically, the 2020 FTC proposed regulations (Prop. Reg. section 1.904-4(e)(2)(ii)) impose a cap on the amount of an insurance company's income that may be treated as active financing income. The cap is determined based on an applicable percentage of the insurance company's total insurance liabilities. Generally, the cap is 200% of total insurance liabilities for a life insurance company and 400% of total liabilities for a nonlife company. To the extent that investment income exceeds the cap, the investment income is not considered ordinary and necessary for the proper conduct of the company's insurance business and will not qualify as active financing income. Prop. Reg. section 1.904-4(e)(2)(ii).

Treasury and the IRS have requested comments on the investment income limitation rule and whether the applicable percentages selected for life and nonlife companies are reasonable.

KPMG observation

The proposed rules defining insurance company active financing income are likely to generate numerous comments from the life and nonlife insurance industry. Treasury did not indicate the basis for the percentage caps; it is expected that industry groups will provide the additional data to support final percentage amounts.

Application of the exempt income / asset rule to insurance companies in connection with certain dividends and tax-exempt interest

The 2019 FTC proposed regulations provided that, in the case of insurance companies, exempt income includes dividends for which a deduction is provided by sections 243(a)(1) and (2) and 245, without regard to the proration rules under section 805(a)4)(A)(ii) disallowing a portion of the deduction attributable to the policyholder's share of the dividends or any similar disallowance under section 805(a)(4)(D). Prop. Reg. section 1.861-8(d)(2)(ii)(B).

One comment requested that the final regulations modify section 1.861-8T(d)(2) to permit insurance companies to adjust the amount of income and assets that are exempted in apportioning deductions. The comment indicated that the adjustment is necessary due to the addition of section 864(e)(7)(E) and supported by the legislative history underlying proposed technical correction legislation (Technical Corrections Act of 1987, H.R. 2636, 100th Cong. Section 112(g)(6)(A)) (June 10, 1987)).

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Treasury and the IRS concluded that, although section 864(e)(7)(E) provides regulatory authority for an insurance company specific rule under section 864()(3), the proposed change was not supported by the enacted statute and subsequent case law, citing *Travelers Insurance Co. v. United States*, 303 F.3d 1373 (Fed. Cir. 2002). Treasury and the IRS concluded that the rule suggested by the comment would inappropriately distort the allocation and apportionment of deductions to U.S. source income. Therefore, the comment was not adopted.

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