KPMG

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# KPMG report: Insurance industry implications of proposed regulations under section 163(j)

Proposed regulations (REG-106089-18) relating to section 163(j) have implications for the insurance industry. Text of the proposed regulations under section 163(j) was released by the IRS last week (the regulations have not yet been released for publication in the Federal Register).

- Read KPMG's report of initial impressions and observations about the proposed regulations under section 163(j): ***TaxNewsFlash***

- Read the text of the proposed 163(j) regulatory package as published on the **IRS website** [PDF 1.5 MB]

Although many insurance companies generally have assumed that section 163(j) would not be a significant burden due to the interest income from their insurance operations, some provisions of the proposed regulations are directly relevant to the insurance industry. These are briefly described below.

**Definition of interest**

The proposed regulations would adopt a broad definition of interest (expense and income) by including not only amounts that would be interest under general tax principles, but also items that would not otherwise be treated as interest for U.S. federal income tax purposes.

As long-term obligations, certain insurance arrangements may include a time value of money aspect. However, the proposed regulations do not extend the section 163(j) definition to insurance arrangements. For example, despite its designation, interest on funds withheld is generally not treated as interest on indebtedness, nor is there any Code section or regulation that would treat interest on funds withheld as interest for

tax purposes. Furthermore, funds-withheld reinsurance is generally not viewed as a transaction the purpose of which is to secure the use of funds for a period of time.

Finally, the preamble to the proposed regulations states that the intent behind the definition of "interest" in the regulations is to "provide a complete definition of interest that addresses all transactions that are commonly understood to produce interest income and expense, including transactions that may otherwise have been entered into to avoid the application of section 163(j)." Therefore, it appears that interest on funds withheld might not be considered subject to section 163(j) or the proposed regulations.

**Consolidated returns**

The proposed regulations generally take a broad, single-entity approach. Consistent with Notice 2018-28, a consolidated group would be subject to a single section 163(j) limitation. This approach mitigates many of the issues presented by the life/non-life consolidation regime. The proposed regulations rejected an expanded definition to include non-consolidated, affiliated companies. Consequently, if there are non-consolidated entities (e.g. stand-alone life insurance companies), the net interest income or expense would be determined separately for each non-consolidated company.

**Treatment of partnership investment income**

The proposed regulations clarify that all interest paid or accrued by a C corporation is treated as business interest expense and that all interest received or accrued is treated as business interest income. In addition, the proposed regulations generally provide that a corporate partner will treat its share of partnership investment income and expenses as properly allocable to a trade or business.

However, as prescribed by the statute, section 163(j) is applied to partnership indebtedness at the partnership level, with the result that the partnership's excess business interest expense will retain its character in the hands of the partner (including a C corporation) and can only be offset in future years by income from the partnership.

**Treatment of insurance controlled foreign corporations**

In general, a foreign corporation will determine its taxable income (but not its earnings and profits) by applying the interest limitation rules of section 163(j). Consequently, section 163(j) would be expected generally to increase the subpart F income and GILTI of U.S. shareholders. In calculating its own section 163(j) limitation, a U.S. shareholder decreases its applicable taxable income (generally, its taxable income without regard to business interest or depreciation and amortization deductions (ATI)) by subpart F income, GILTI, and the section 78 gross-up (net of the section 250 deduction without regard to the taxable income limitation). Thus, this income cannot be used to increase the U.S. shareholder's section 163(j) limitation.

A special election would be available, however, for CFCs that are at least 80% owned by a single U.S. shareholder or by multiple U.S. shareholders that are related persons. Under this election, the CFC group would determine its applicable net interest expense (the excess, if any, of the aggregate business interest expense of group members over their aggregate business interest income) and allocate it among its members that have interest expense in excess of interest income. This has the effect of netting interest income and expense for intragroup borrowing. Thus, for example, if the total interest income of the CFC group exceeded its total interest expense, the section 163(j) limitation would not apply to any of the CFCs in the group even if individually some had interest expense that exceeded interest income. A member would be subject to the section 163(j) limitation only to the extent that its allocable portion of the applicable net interest expense exceeded 30% of the CFC's ATI. In addition to the group-wide determination of applicable net interest expense, if a group election is made, CFC excess taxable income (e.g., the portion of the CFC's ATI that did not "absorb" its portion of the applicable net interest expense) would "tier up" to the next higher level of CFC and would be included in that CFC's ATI.

Thus, the determination of each CFC's section 163(j) limit is determined from the lowest level to the top level, and any excess taxable income of the top-level CFC is included in the ATI of its U.S. shareholders that are part of the 80% ownership group.

Financial services entities, however, would be subject to a special sub-grouping rule. For purposes of determining and allocating applicable net interest expense, the election would treat certain CFCs that are actively engaged in financial services businesses, including CFCs that are qualifying insurance companies within the meaning of section 953(e)(3), as a separate group. Although the preamble states that this subgrouping rule is intended to avoid distortions created by including in the general group any CFCs that tend to have a disproportionate amount of business interest income or expense, the rule itself could create distortions by excluding from the subgroup a finance or treasury operation that centralizes borrowing in a separate entity that is not a qualifying insurance company, or by excluding CFCs that are active, regulated insurance companies that do not meet the 50% home country net written premium requirement of section 953(e)(3).

For more information, contact a KPMG tax professional:

Clarissa Potter | +1 212 872 6913 | clarissapotter@kpmg.com

Sheryl Flum | +1 (202) 533-3394 | sflum@kpmg.com

Fred Campbell-Mohn | +1 (212) 954-8316 | fcampbellmohn@kpmg.com

Stuart Katz | +1 212 954 6674 | stuartkatz@kpmg.com

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