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KPMG report: Final regulations on consolidated NOLs, inclusive of insurance company regulations

The IRS on October 13, 2020, posted to its website a version of final regulations (T.D. 9927) under sections 172 and 1502 as guidance relating to the absorption of consolidated net operating loss (NOL) carryovers and carrybacks.

A significant portion of the provisions in the final regulations focuses on the utilization of nonlife losses within a consolidated group. The regulations also update the life-nonlife consolidated return regulations under Reg. section 1.1502-47.

- Read the **final regulations** [PDF 475 KB] (84 pages) that finalized regulations as proposed in July 2020.
- Read ***TaxNewsFlash*** (July 2020) that focuses on implications of the proposed regulations regarding the treatment of consolidated NOLs of life insurance companies.

This edition of *TaxNewsFlash* summarizes some of the comment letters that Treasury and the IRS received regarding insurance topics presented in the proposed regulations and the responses of Treasury and the IRS as reflected in the final regulations.

Background

The 2017 tax law (Pub. L. No. 115-97) that is often referred to as the "Tax Cuts and Jobs Act" (TCJA) and subsequently the "Coronavirus Aid, Relief, and Economic Security Act" (CARES Act) (Pub. L. No. 116-136) amended the rules for NOLs. After amendment, the NOL deduction is the sum of:

- The total of the NOLs arising before January 1, 2018 (pre-2018 NOLs) that are carried to that year; plus
- The lesser of:
    - The total of the NOLs arising after December 31, 2017, or
    - 80% of taxable income less pre-2018 NOLs (the 80% limitation)

The TCJA generally eliminated NOL carrybacks and permitted NOLs to be carried forward indefinitely, subject to the 80% limitation. However, the TCJA provided special rules for nonlife insurance companies and farming losses. Nonlife insurance companies are permitted to carry back NOLs two years and forward 20 years, and the 80% limitation does not apply. Similarly, farming losses are permitted to be carried back two years and carried forward indefinitely, subject to the 80% limitation. Pre-TCJA law continues to apply to NOLs arising in pre-effective date years.

The CARES Act effectively delayed application of the TCJA amendments until January 1, 2021. Additionally, the CARES Act permits a five-year carryback for NOLs, including farming losses and NOLs of nonlife insurance companies, for tax years beginning after December 31, 2017, and before January 1, 2021.

In July 2020, **proposed regulations** [PDF 411 KB] set forth proposed amendments to the consolidated return regulations under section 1502. The proposed regulations also provided guidance implementing recent statutory amendments to section 172, and updated the regulations applicable to consolidated groups that include both life insurance companies and other companies ("life-nonlife" consolidated return regulations).

Final regulations released

The IRS on October 13, 2020, posted to its website a version of the final regulations (T.D. 9927) under sections 1502 and 172 as guidance relating to the absorption of consolidated NOL carryovers and carrybacks. The guidance updates regulations applicable to consolidated groups that include both life insurance companies and other companies as well as consolidated returns.

NOLs and insurance companies

The final regulations are consistent with the proposed regulations, and clarify the application of the ability of nonlife insurance companies to carry back losses within a consolidated group that includes non-insurance companies that are generally not eligible to carry back ordinary losses. The regulations formalize a two-factor approach if a consolidated group comprises both nonlife insurance companies and other members in a consolidated return year beginning after December 31, 2020. In general, the post-2017 consolidated NOL deduction limit for the group equals the sum of two parts.

- The first part relates to the income of the non-insurance companies. In general, the loss carryback is limited to an amount no greater than 80% of the group's consolidated taxable income (determined without regard to the income or losses attributable to nonlife insurance companies).
- The second part relates to the income of nonlife insurance companies. This part generally equals 100% of the consolidated net income attributable to the nonlife insurance companies.

These parts are adjusted for any deductions under sections 172, 199A, and 250.

The final regulations further provide that the amount of post-2017 consolidated NOLs (CNOLs) that may be absorbed by one or more members of the group in such a consolidated return year (post-2017 CNOL deduction limit) is determined by applying the 80% limitation, or section 172(f) (that is, the special rule for nonlife insurance companies), or both, to the group's consolidated taxable income for that year.

For consolidated groups that include both nonlife insurance companies and other members for a consolidated return year beginning after December 31, 2020, the final regulations adopted a two-factor computation. The post-2017 NOL deduction limit for such a group equals the sum of two amounts.

- The first amount is the income of life insurance companies (residual income pool), and is subject to the 80% limitation.

- The second amount is income of those members that are nonlife insurance companies (nonlife income pool), and is not subject to the 80% limitation.

The IRS also explored and rejected an alternative approach which would have required a group to first offset income and loss items within a pool of nonlife insurance companies and a pool of all other members. Comments were consistently opposed to the alternative approach as being inconsistent with the historical application of Reg. section 1.1502-21(b)(2)(iv)(B). The final regulations retained the proposed approach to computing a consolidated group's post-2017 CNOL deduction limit.

Dual consolidated losses

One group of comments requested a clarification of the application of the separate return limitation year (SRLY) rules to the dual consolidated loss (DCL) rules. The proposed SRLY rules incorporate the limitations on NOL deductions under section 172, as amended by the TCJA and the CARES Act. See Prop. Reg. section 1.1502-21(c)(1)(i)(E). The comments requested that these rules not apply for purposes of how the section 1503(d) limitation is computed with respect to the absorption of DCLs.

Under section 1503(d) and the applicable regulations, the DCL rules generally incorporate the mechanics of the SRLY rules. However, the comments noted that, in contrast to the SRLY rules, a DCL can be incurred in (and economically attributable to) any year, including years when the loss generating member is included in a consolidated group (regardless of the period economically incurred). The Treasury Department agreed with these comments; the final regulations provide that Reg. section 1.1502-21(c)(1)(i)(E) does not apply for purposes of the DCL rules. See Reg. section 1.1503(d)-4(c)(3)(v).

Consolidated capital gain net income

Several comments requested additional guidance with respect to the allocation of capital gain net income among members. Specifically, one comment asked Treasury to clarify that consolidated capital gain net income under Reg. section 1.1502-11 is allocated to the residual income pool and the nonlife income pool using a pro-rata method similar to the method used in Prop. Reg. section 1.1502-21 for the use and absorption of CNOLs. Another comment suggested that amounts of the residual income pool and the nonlife income pool in Prop. Reg. section 1.1502-21(a)(2)(ii)(C)(2) and (3) be clarified to refer only to the items of income, gain, deduction or loss of member of the nonlife subgroup. Nonlife CNOL should still be able to offset life subgroup income where permitted by the Code and Reg. section 1502-47.

In addition, one comment asked that the final regulations clarify how much taxable income in each pool is absorbed by a CNOL carryover when each pool has positive taxable income. The comment argued that this absorption rule is needed to determine much residual income pool taxable income that is subject to the 80% limitation can be offset by subsequent CNOL carryover to the same year. The comment recommended that the taxable income absorption determined using a pro-rata method with the denominator of the fraction equal to the group's potential CNOL deduction limit. The denominator of the fraction should not include the 20% of the taxable income of the residual income pool that is not available to be offset by a CNOL.

In the preamble to the final regulations, Treasury noted it believes that, absent express rules, taxpayers generally apply the principles of Reg. section 1.1502-22(b)(2)(iv) to make such determinations. Treasury indicated that, in general, the methodology for computing a consolidated group's post-2017 CNOL deduction limit is intended to be flexible for taxpayers to apply and administrable for the IRS. Without specifically agreeing or disagreeing with the comments, Treasury concluded that specific rules in this area would exceed the scope of the final regulations.

Life-nonlife regulations (Reg. section 1.1502-47)

Several comments appreciated Treasury's proposed amendments to Reg. section 1.1502-47 to be consistent with the current statutory provisions of subchapter L. Two comments, however, noted that certain substantive premises underlying the life-nonlife consolidated return regulations are outdated and unnecessary. These regulations do not reflect fundamental changes to the taxation of both life and property and casualty insurance companies that were enacted subsequent to the regulations originally being finalized in 1983. These comments strongly advocated additional substantive revision to reflect changes in the tax law over the past 37 years. in general, the comments argued that the life-nonlife regulations should be updated to reflect the principles of the broader consolidated returns whenever possible.

Treasury stated that it appreciated the comments and welcome further comments regarding substantive changes to Reg. section 1.1502-47 but demurred on providing further guidance because such changes are beyond the scope of these regulations.

Treasury did incorporate several suggested clarifying changes to the proposed regulations. However, it rejected several comments as outside the scope of these final regulations. Specifically, one comment suggested that the provisions under Reg. section 1.1502-47(g)(3) relating to life consolidated net capital loss carryovers be modified to be more closely parallel to the analogous rules for nonlife consolidated net capital loss carryovers. In addition, the comment recommended specific rules to cover situations in which an includible member of a life-nonlife consolidated return could receive dividends from another member of the group (with group determined under section 1504(c)(2)(A) without regard to the section 1504(b)(2) exclusion of life insurance companies). Treasury demurred and indicated that it will continue to consider these comments for purposes of potential future guidance regarding Reg. section 1.1502-47.

Effective dates

Under Prop. Reg. section 1.1502-47(n), Treasury proposed to retain the original effective date of the regulations, but added a new paragraph:

> *The rules of paragraphs (a)(2)(i), (a)(2)(ii), (b)(1) through (b)(4), (b)(9), (b)(10), (b)(12), (b)(13)(ii), (d)(5)(i), (d)(7)(ii), (f)(2)(iii), (f)(2)(vi), (f)(2)(vii), (f)(3)(ii), (g), (h)(4)(ii), (h)(4)(iii) and (j)(3)…*

apply to tax years beginning after the effective date of the final regulations.

One comment indicated that this paragraph-by-paragraph effective date seemed cumbersome, and could lead to confusion and potentially to controversy. The comment suggested that the updated Reg. section 1.1502-47 be made effective in its entirety for tax years beginning after the publication of the final regulations in the Federal Register.

KPMG observation

The final regulations confirm the understanding of insurance companies on how the consolidated net operating rules should be applied by a consolidated group that consists of both nonlife insurance companies and non-insurance companies. Treasury's approach is consistent with the pre-existing regulations under Reg. section 1.1502-21.

In addition, the final regulations take a first step forward to update Reg. section 1.1502-47. The prior regulations were finalized under the three-phase tax regime for life insurance companies under the 1959 Act. Unfortunately, Treasury circumscribed the scope of the regulations to exclude revisiting the underlying premises of the existing rules under Reg. section 1.1502-47. Insurance companies may want to continue to foster this dialogue with Treasury to initiate an expanded regulation project that allows for further updates to the life-nonlife consolidated regulations.

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