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Corporate Inversions

Treasury Looking at Alternatives to E&P Exception in Earnings-Stripping Rules

The government is taking another look at the exception for earnings and profits under controversial earnings-stripping rules, Treasury Deputy International Tax Counsel Douglas Poms said.

That issue has been a major one for taxpayers who say current-year E&P is tough to figure out—something especially difficult for insurance companies seeking relief from rules intended to curb companies from moving profits out of the U.S. via loans to subsidiaries.

Speaking at the Federal Bar Association Section on Taxation's insurance tax seminar June 3, Poms said Treasury is listening to growing concerns from that industry and others on the E&P issue. He asked for ''constructive ideas'' on changes that would help preserve the government's objective in offering exceptions.

One possible alternative, he said, is looking at prior-year E&P.

Insurance Company Concerns. As part of a broader effort to finalize the rules, Poms and other officials said Treasury is willing to listen to other worries in the insurance arena, including the fate of loans between life and nonlife companies and the potential treatment of financing common to the industry known as ''surplus notes.''

Proposed in April, the rules (REG-108060-15) call for some types of loans between related parties in expanded affiliated groups to be recast as involving equity, or stock, rather than debt—causing deductions on loan interest payments to disappear and saddling companies with a heavy burden of withholding taxes. The IRS also could bifurcate loans into part debt and part equity (65 DTR GG-1, 4/5/16).

'Seismic Shift.' If the rules are finalized in their current form, it would represent ''a seismic shift'' in the tax treatment of loan financing for both multinational and domestic companies, panelist Mitchell Weiss, of Deloitte Tax LLP, said.

Weiss and other panelists said the E&P exception in the proposed rules probably wouldn't do insurance companies much good.

These companies frequently have to deal with unexpected events and other uncertainties that make E&P calculations in a current year tough, if not impossible, panel moderator Brenda Viehe-Naess, of Washington Advocates Group, said. ''Some insurance companies may never be able to do it, or may make distributions that could be disqualified,'' she said. In some cases, these companies calculate their E&P in the following year, she told officials.

Concern for Insurance Industry. Weiss said if the exception is finalized as proposed, it could cause numerous debt instruments that are worth more than the E&P to be bifurcated.

Poms said the government has been hearing this concern across multiple industries and ''it's definitely something that we are looking at comments for and considering what we might do.'' One possibility, he said, is looking at the prior-year E&P. He said Treasury is willing to consider ''variations'' that would be more helpful in accomplishing the government's objectives.

''It's really helpful if, when you provide comments, you come up with constructive ideas in providing a similar exception,'' Poms said.

Panelist Raymond J. Stahl, assistant to the Branch 5 chief of the IRS Office of Associate Chief Counsel (International), pointed to language in the preamble to the rules stating that the government is hoping to provide equal relief to distributions made in the ordinary course of business.

Worry About Surplus Notes. In another key concern for the insurance industry, Weiss asked whether the government plans to exercise its discretion to bifurcate a financing tool common to the industry known as a ''surplus note.''

Insurance companies issue these notes to bolster surplus capital, and their structure means that companies might not be able to entirely repay the interest and principal on these instruments on the day they are issued, Weiss said. The industry is worried because taxpayers have to show they reasonably expect repayment to have loans treated as debt under the rules.

Poms said it is too early to say how the government might approach a specific fact pattern such as Weiss outlined, but added, ''We will take into consideration all the comments.'' He said a Treasury goal is to ''make sure we don't prescribe a rule that is not possible to comply with.''

Life, Nonlife Companies Fear Loan Recasts. Another big worry, the Deloitte practitioner said, is the potential recasts of loans involving life and nonlife companies.

The rules exclude transactions done within consolidated groups, but in some cases, life and nonlife companies within an affiliated group aren't allowed to consolidate for a period of time, and could each be considered a consolidated group on its own. Intercompany loans could be treated as being done between two consolidated groups, which could trigger the rules, Weiss

said —an outcome that is creating ''doom and gloom in the insurance industry.''

The IRS's Stahl said it's ''worth noting'' that one of the reasons the government turned off the rules for debt issued from one consolidated group member to another was that all the information regarding the loan would be reflected on one tax return.

''That is the starting point in thinking about these provisions,'' he said. ''On the other hand, it's important for us to understand. We definitely appreciate comments about certain industry-specific cases where, notwithstanding the fact that you have separate returns,'' there could be scenarios where relief could be provided.

BY ALISON BENNETT

To contact the reporter on this story: Alison Bennett in Washington at abennett@bna.com

To contact the editor responsible for this story: Cheryl Saenz at csaenz@bna.com

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