POINTS TO **REMEMBER**

INTRODUCTION:
The Points to Remember in this issue focus on recent legislation, regulations, and other guidance in two practice areas: international and employee benefits. Neil Feinstein and David McGinty highlight legislation, final regulations, and proposed regulations affecting multinational corporations. David Pratt examines significant legislation, and initial guidance, related to employee benefits.
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GLOBAL PLANNING TODAY: **RECENT U.S. TAX DEVELOPMENTS AFFECTING MNCS**

*by Neil H. Feinstein and David B. McGinty**

Numerous U.S. tax rules affecting multinational corporations (MNCs) have been changed in the past year. This Point to Remember briefly describes statutory and regulatory changes and provides a high-level look at their impact on MNCs. In part, MNCs will need to reevaluate controlled foreign corporation (CFC) structures and foreign tax credit splitters, adjust how they account for foreign currency gains and losses relating to qualified business units (QBUs), consider new earnings and profits (E&P) carry-over rules in tax-free asset acquisitions, adjust the basis of CFCs held through partnerships for apportioning interest, and revise previously taxed income (PTI) accounts for stock in CFCs.

SUBPART F INCOME

The Tax Increase Prevention and Reconciliation Act of 2005 creates a new exception in section 954(c)(6) to subpart F income for dividends, interest, rents, and royalties received from a related CFC. The exception applies if the income is attributable or properly allocable to income of the payor that is not subpart F income. New section 954(c)(6) affords MNCs more freedom to move cash among their CFCs without creating subpart F income. The new provision is not permanent. It applies only to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009.

SECTION **987**

Proposed regulations have been issued under section 987. The new proposed regulations replace proposed regulations issued in 1991. These rules apply to QBUs whose functional currency is not the same as the taxpayer's. Different currency translation rules apply to so-called "marked items" and "historic items."

The proposed regulations adopt a new method, the "foreign exchange exposure pool method," for computing exchange gains and losses on remittances. A taxpayer would translate the QBU's opening and closing balance sheets into the functional currency used by the taxpayer. It would translate "marked items" at the spot exchange rate as of the beginning and end of the year. It would translate all other items, "historic items," at their "historic exchange rates"—generally, the spot rate on the date the asset was acquired by (or liability incurred or transferred to) the QBU.

Generally, marked items are items that would be section 988 transactions if entered into directly by the taxpayer. The difference between the beginning and ending balance sheets (with adjustments) represents unrealized exchange gain or loss that goes into the "foreign exchange exposure pool." On receiving a remittance, the taxpayer would recognize a portion of the pool based on the portion of the QBU's gross assets that are remitted. The new rules would also require the QBU to translate depreciation, depletion, and amortization on—and the adjusted bases of—historic assets at historic exchange rates in computing its taxable income or loss.

These new rules are proposed to be effective for taxable years beginning one year after the proposed regulations are finalized. A taxpayer may elect to apply the new rules for the first taxable year after the rules are finalized. The proposed regulations also include two elective transition rules.

FOREIGN **TAX CREDITS**

Proposed regulations have been issued that address structures commonly called "foreign tax credit splitters." These structures typically involve the use of foreign consolidation-type régimes and "reverse hybrids" (partnerships for foreign tax purposes that have elected to be treated as corporations for U.S. tax purposes) to separate foreign tax from the related foreign income. Current regulations provide that the person by whom tax is considered paid is the person on whom foreign law imposes legal liability for the tax. If taxes are imposed on the combined income of two or more persons, foreign law is considered to impose legal liability on each such person for the amount of the tax attributable to its portion of the base of the tax. It does not matter which person paid the tax. Because this rule explicitly applies only if there is joint and several liability for the tax, taxpayers have argued that foreign law imposes the sole liability

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on an entity that does not earn the related income for U.S. income tax purposes (the foreign parent under some consolidation-type regimes and the partners in a reverse hybrid).

The proposed regulations clarify that foreign law is considered to impose legal liability for income taxes on the person who is required to take the associated income into account for foreign tax purposes even if another person has the sole obligation to remit the tax. They provide detailed guidance on how to treat taxes paid on the combined income of two or more persons regardless of whether joint and several liability exists. The tax on such income must be apportioned among all the members pro rata based on the relative amounts of net income earned by each member as computed under foreign law. Moreover, the proposed regulations provide that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on the owner's share of the reverse hybrid's income.

The new rules are proposed to be effective for foreign tax paid or accrued during taxable years beginning on or after January 1, 2007.

Given these proposed regulations, planners should re-evaluate foreign tax credit splitters because future foreign taxes may be allocated under the new rules to the low-tax E&P pools created in the foreign tax credit splitter structures.

EARNINGS AND **PROFITS**

New final regulations under section 367(b) concern the carryover of foreign E&P (or deficit) and income taxes in tax-free corporate asset acquisitions.

These regulations include the following rules:

- E&P (or deficit) of a foreign acquired corporation that is not included in income as a deemed dividend under section 367(b) will carry over to a U.S. acquirer only to the extent such E&P (or deficit) is effectively connected with the conduct of a U.S. trade or business or attributable to a permanent establishment in the U.S. All other E&P (or deficit) is eliminated.
- A deficit in a section 904(d) category of post-1986 accumulated earnings of a foreign acquired or acquiring corporation offsets only E&P of the foreign surviving corporation accumulated after the transaction in the same category. The offset occurs as of the first day of the first year of the surviving corporation after the acquisition.
- Post-1986 foreign income taxes related to a hovering deficit are added to the foreign surviving corporation's tax pools only as the deficit is absorbed.

The regulations also contain rules addressing three other situations: the carryover of deficits to certain surviving foreign corporations that are not "pooling corporations" (corporations with respect to which the requirements of section 902(c)(3)(B) have not been met in the current or any prior year); the carryover of pre-1987 accumulated profits; the affect of deficit carryovers on subpart F income; and the carryover of deficits in F reorganizations and similar transactions.

These rules are effective for transactions that occur on or after November 6, 2006.

PARTNERSHIP **HOLDING COMPANIES**

For purposes of applying the tax book value method for apportioning interest expense, Treas. Reg. § 1.861-12T(c) requires the basis of stock in a "10 percent owned corporation" to be increased or decreased by the E&P (or deficit) in E&P of such corporation (and of lower tier 10 percent owned corporations). MNCs have avoided basis increases (and, as a consequence, additional interest expense allocated to foreign source income) by holding stock of foreign corporations through a partnership. MNCs have asserted the regulation does not apply in such circumstances.

Effective for taxable years beginning after April 25, 2006, the regulation requires the basis of a 10 percent owned corporation to be adjusted when held through a partnership.

PREVIOUSLY **TAXED INCOME**

Proposed regulations under section 959 revamp the rules concerning PTI. The new rules are intended to allow U.S. shareholders of CFCs to receive the full benefit of their PTI at the earliest possible time.

Under the proposed regulations, each U.S. shareholder must maintain a PTI account for each share or block of stock in a foreign corporation that the shareholder owns directly or indirectly. The proposed regulations contain PTI sharing rules. If a distribution on a share in a CFC exceeds the PTI account for the share, the U.S. shareholder's PTI accounts with respect to its other shares in the CFC are used to cover the distribution. (A similar rule applies in the case of section 956 amounts.) If a distribution exceeds the PTI accounts with respect to all of that shareholder's shares, the PTI accounts of other members of the shareholder's consolidated group are used to cover the distribution. The proposed regulations provide detailed rules to account for the PTI sharing, including how to adjust PTI accounts and share bases.

The proposed regulations follow Rev. Rul. 82-16, 82-1 C.B. 106, concerning the exclusion from income under section 959(b) with respect to CFC-to-CFC distributions. In the ruling, a CFC was owned 70 percent by a U.S person and 30 percent by a foreign person. The CFC received a $200 distribution from a lower-tier CFC, which had earned $100 of subpart F income (of which $70 was included in income by the U.S. person) and $100 of other E&P. The ruling held that all $100 (and not just $70) was excluded from the upper-tier CFC's income. The proposed regulations provide that the amount of the exclusion under section 959(b) is the

entire amount of a distribution by a lower-tier CFC to an upper-tier CFC that gave rise (in whole or in part) to an adjustment to the U.S. shareholder's PTI accounts.

The new rules are proposed to apply to taxable years of foreign corporations beginning on or after final regulations are finalized and taxable years of U.S. shareholders with or within such taxable years.

SIGNIFICANT CHANGES AFFECTING EMPLOYEE BENEFITS

*by David Pratt**

This Point to Remember summarizes significant recent employee benefits changes made by the Pension Protection Act of 2006 (PPA) and the Tax Relief and Health Care Act of 2006. Recent agency guidance is also included. Additional details about these changes appear in articles available at **www.benefitslink.com**.

PENSION PROTECTION ACT OF 2006

Pension Funding: The centerpiece of the PPA is a set of complex new rules that strengthen the minimum funding requirements for private sector defined benefit plans. Although the government's goal is to improve the funded status of these plans, critics fear that the additional funding requirements, coupled with new accounting requirements, are more likely to hasten the demise of private sector defined benefit plans.

EGTRRA Permanence: Section 811 of the PPA makes permanent the many pension changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), including increased contribution and benefit limitations under section 415 and increased 401(k) deferrals under section 402(g).

Rollovers by Non-Spouses: Under prior law, a surviving spouse beneficiary could roll over benefits to the spouse's IRA or another qualified plan. Non-spouse beneficiaries could not. Effective for distributions after December 31, 2006, section 829 of the PPA allows a non-spouse beneficiary to make a *direct transfer* (not a rollover) to an IRA from a qualified plan, a governmental section 457 plan, or a section 403(b) plan. Unlike spouses, non-spouse beneficiaries may move funds only to an IRA. *See also* Notice 2007-7, 2007-5 I.R.B. 395, Q & A 11 through 19.

Direct Rollovers to Roth IRAs: Effective for distributions *after 2007*, section 824 of the PPA allows a rollover directly from a qualified plan, section 403(b) plan, or governmental section 457 plan (but not from an IRA) to a Roth IRA. Previously, a rollover had to be made to a traditional IRA that was then converted into a Roth IRA. Such rollovers are subject to several rules, which also apply to conversions from traditional IRAs to Roth IRAs. First, the taxpayer must include the distribution in taxable income (except for after-tax funds). Second, the conversion is not subject to the 10 percent early withdrawal tax. Third, for 2008 and 2009, only a taxpayer with adjusted gross income of $100,000 or less is eligible. (The Tax Increase Prevention and Reconciliation Act of 2005 eliminates the $100,000 limit after 2009.)

Rollovers of After-Tax Amounts: Previously, after-tax amounts could be rolled over directly from a qualified plan to another qualified plan, or from a section 403(b) plan to another section 403(b) plan, but could not be moved from a qualified plan to a section 403(b) plan, or vice-versa. Section 822 of the PPA permits direct rollovers of after-tax amounts from a qualified plan to a defined contribution plan, defined benefit plan, or tax-deferred annuity. The change does *not* allow after-tax funds to be rolled over from a section 403(b) plan to a qualified plan.

New Early Withdrawal Exceptions: Section 72(t) imposes an additional income tax on most distributions made by a tax-favored retirement arrangement before the beneficiary reaches age 59 1/2. This rule had numerous exceptions under prior law. Section 828 of the PPA adds new exceptions for (1) any qualified reservist distribution and (2) distributions from a governmental defined benefit plan to a public safety employee, after separation from service after the attainment of age 50. *See* Notice 2007-7, *supra*, Q & A 6 through 10.

Automatic Enrollment Arrangements: Section 902 of the PPA includes provisions to encourage automatic enrollment programs, generally effective for plan years beginning *after* December 31, 2007.

Distributions to Charity: Section 1201 of the PPA provides an exclusion from gross income for certain distributions in *2006 and 2007* from a traditional IRA or Roth IRA (but not a SIMPLE IRA or SEP) that are paid *directly* by the IRA to a charity. Several limitations apply. The taxpayer must be at least 70 1/2; the exclusion is limited to $100,000 per taxpayer per year; and the exclusion applies only if the entire charitable distribution would be deductible, without taking into account the percentage limitations based on adjusted gross income.

Amounts donated to charity count as minimum required distributions, but these excluded distributions are not deductible under section 170. Certain organizations are not eligible to receive excludible distributions. These include donor advised funds and certain private foundations. The Service has issued a procedure for changing a charity's classification to allow it to become eligible. *See* Ann. 2006-93, 2006-48 I.R.B. 1017. *See also* Notice 2007-7, *supra*, Q & A 34 through 44.

The Saver's Credit: Sections 812 and 833(a) of the PPA make the credit permanent and provide that the income limits will be indexed for inflation.

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