

US Inbound Newsalert

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Obama Administration's FY 2013 Budget: Re-proposals and new international tax provisions

On February 13, 2012, the Office of Management and Budget ("OMB") released a proposed federal budget for fiscal year 2013 (the "Budget") and the US Treasury Department released its General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals, also known as the "Green Book".

The Budget re-proposes three tax provisions which the Obama Administration had proposed as part of the FY 2011 and FY 2012 Budgets that would have significant implications for foreign-based multinational corporations ("MNCs") and their US subsidiaries. These proposals would:

- (1) Disallow certain deductions for non-taxed reinsurance premiums paid to foreign affiliates;
- (2) Limit interest deductions by expatriated entities; and
- (3) Repeal the boot-with-gain limitation for certain distributions received in reorganization exchanges.

The proposals to disallow certain deductions for non-taxed reinsurance premiums paid to foreign affiliates, limit interest deductions by expatriated entities, and repeal the boot-with-gain limitation applicable to certain distributions received in reorganization exchanges generally were unchanged from last year's Green Book except to delay the effective date to taxable years beginning after December 31, 2012.



The Budget also introduces an additional proposal that may significantly impact certain MNCs. Under this proposal, the gain or loss from the sale of a partnership interest would be treated as income effectively connected with the conduct of a US trade or business ("ECI") to the extent the selling partner's share of the unrealized gain or loss is attributable to property giving rise to ECI. In addition, the proposal would impose certification and withholding requirements. The proposal would create a withholding regime, similar to that applicable to dispositions of US real property interests, requiring the purchaser of a partnership interest from a foreign partner to withhold on the purchase price if that partnership is engaged in a US trade or business.

The Treasury estimates that this provision will raise approximately \$3.6 billion over the ten-year period following its enactment. We note that the revenue estimates expected to be provided by the US Congressional Joint Committee on Taxation, which may differ from the Treasury's estimate, will represent the official revenue estimates of Budget proposals.

The Green Book also includes several proposals that reintroduce FY 2011 and FY 2012 proposals regarding deferral and foreign tax credits. While these proposals have the greatest impact on US-based MNCs, they also may be relevant to foreign-based MNCs with foreign subsidiaries that are considered US-controlled foreign corporations for US federal tax purposes. For a detailed discussion of these proposals, please see our forthcoming *US Outbound Newsalert*.

The following provides a brief overview of the newly proposed tax on gain from the sale of a partnership interest, which may be particularly relevant to the US inbound community. Given that this proposal and most of the re-proposals would become effective for taxable years beginning after December 31, 2012, foreign-based MNCs and their US subsidiaries should begin determining how these proposals may impact their US federal income tax liabilities and the extent to which they can manage such impact through changes to their organizational structures and business operations.

New proposal to tax gain from the sale of certain partnership interests as ECI

For US federal income tax purposes, the sale or exchange of a partnership interest generally is treated as the sale or exchange of a capital asset. Capital gains of a nonresident alien individual or foreign corporation generally are subject to US federal income tax only if the gains are treated as ECI. Although no provision of the Code explicitly provides that gain from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is treated as ECI, the Internal Revenue Service (the "IRS") held in Revenue Ruling 91-32 that gain or loss from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is ECI to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to ECI property (i.e., property that is used or held for use in the partnership's trade or business within the United States). Several commentators have questioned the basis for the IRS's position and the Green Book points out that taxpayers may have taken a position contrary to the IRS's position. The Administration's proposal effectively would codify the holding of Revenue Ruling 91-32 by treating gain or loss from the sale or exchange of a partnership interest as ECI to the extent such gain or loss is attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss attributable to ECI property. The proposal would be effective for sales or exchanges after December 31, 2012.

The Administration's proposal also imposes withholding and certification requirements similar to those required under the Foreign Investment in Real Property Tax Act ("FIRPTA") provisions of the Code and corresponding Treasury regulations. More specifically, the Administration's proposal requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or a foreign corporation. A transferee may withhold a lesser amount if the transferor provides a certificate from the IRS establishing that the transferor's US federal income tax liability with respect to the transfer was less than 10 percent of the amount realized. If the transferee fails to withhold the correct amount, the partnership would be liable for the amount of underwithholding and would satisfy the obligation by withholding on future distributions that otherwise would have been paid to the transferee partner.

Observations: It is understood that this proposal is intended to address the policy concern that a nonresident alien individual or foreign partner may sell or exchange a partnership interest tax-free, while at the same time providing a transferee an increase or 'step-up' in the basis of the value of the partnership interest, thus permanently avoiding US federal income tax on any built-in gain. Under the Obama Administration's proposal, the sale of a partnership interest would be a taxable event such that permitting a transferee to take a step-up in the basis of the partnership interest should be consistent with current taxation of any gain from the sale of the partnership interest.

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