



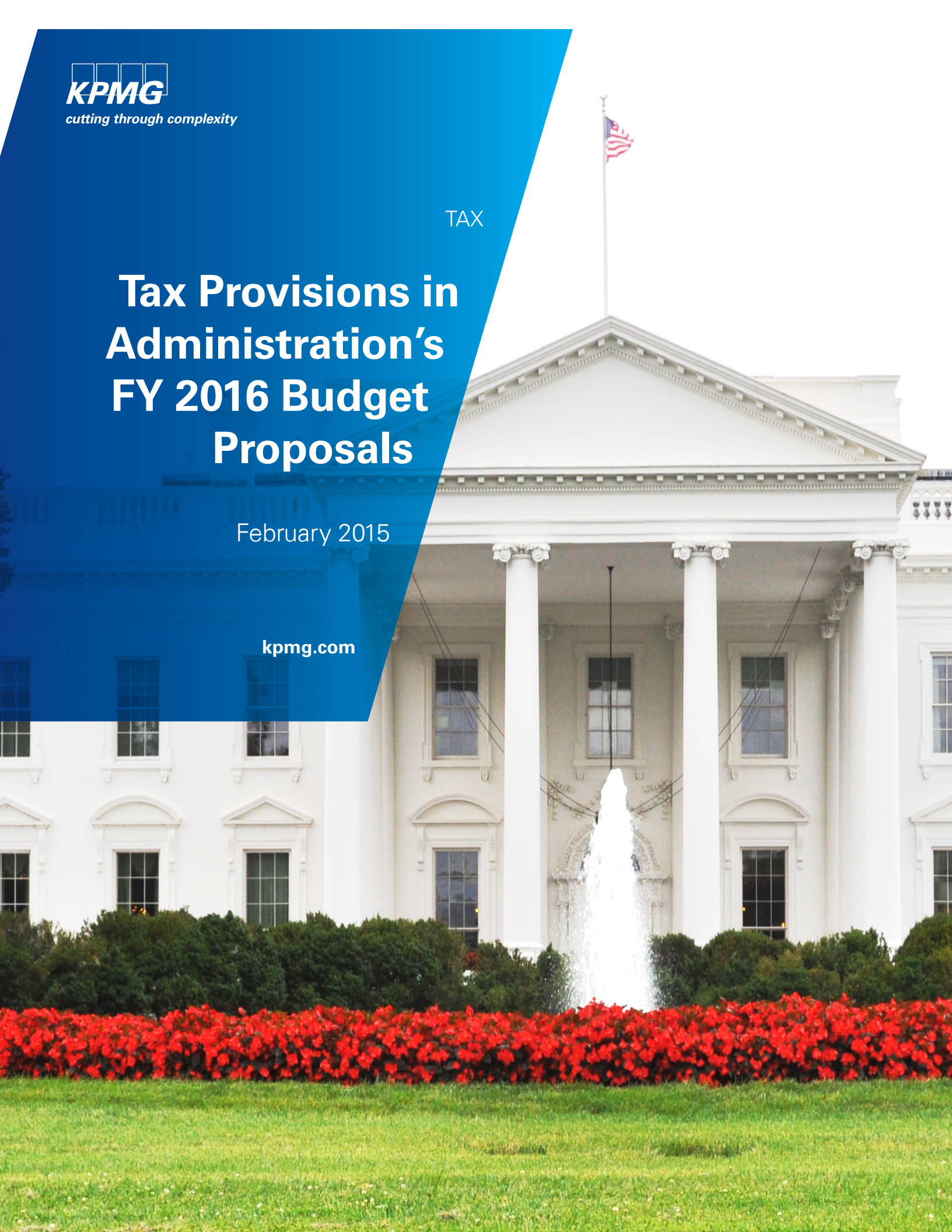
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TAX

# Tax Provisions in Administration's FY 2016 Budget Proposals

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# TAX PROVISIONS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET

## Executive summary

President Obama, on February 2, transmitted to Congress his fiscal year (FY) 2016 budget, containing the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015.

## Overview

The president proposes expenditures for discretionary programs at \$74 billion above the spending caps set in the *Budget Control Act of 2011*. The total proposed FY 2016 spending reflected in the administration's budget is \$4 trillion, of which \$1.09 trillion is proposed for discretionary spending programs, divided roughly equally between defense (\$561 billion) and nondefense (\$530 billion) discretionary programs.

The president also proposes a six-year \$478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations.

The tax on unrepatriated earnings would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate.

The budget includes a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

For individuals, the president proposes important changes in the taxation of capital gains. The rate of tax on capital gains would be increased to a maximum rate of 28% for higher earning individuals. In addition, bequests and gifts would be treated as realization events for purposes of taxing capital gains—a fundamental change in the taxation of bequests and gifts.

## Business tax revisions

Many other tax proposals in the FY 2016 budget are familiar, having been included in previous budgets, such as:

- Reforms to the international tax system

- Limiting the ability of domestic entities to expatriate
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Mark-to-market of financial derivatives
- Modification of the like-kind exchange rules
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation
- Make permanent the subpart F exception for active financing income
- Make permanent look-through treatment of payments between related CFCs

Some previous proposals have been modified significantly.

The president repropose a tax on the liabilities of financial institutions with assets in excess of \$50 billion. The rate would be reduced from 17 basis points to seven basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget.

The FY 2016 budget also includes a fundamental reform of the system of taxation of the foreign earnings of U.S. companies, which would raise \$474 billion over 10 years.

In place of the current system of deferral, the budget proposal would impose a minimum tax on foreign earnings above a risk-free return on equity invested in active assets. The minimum tax, imposed on a country-by-country basis, would be set at 19% less 85% of the per-country foreign effective tax rate. The new minimum tax would be imposed on a current basis, and foreign earnings could then be repatriated without further U.S. tax liability.

As part of the transition to the new system of taxation of foreign earnings, the budget would also impose a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to U.S. tax. A foreign tax credit would be allowed for foreign taxes associated with those earnings, reduced in proportion to the one-time tax rate relative to the maximum corporate rate. The transition tax would be payable ratably over five years.

## Individual tax revisions

As in the case of businesses, many of the individual (personal) tax proposals in the budget are familiar, including:

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the “Fair Share Tax”) of 30% of AGI
- Limit the total accrual of tax-advantaged retirement benefits
- Conform SECA taxes for professional service businesses
- Restore the estate, gift, and GST parameters to those in effect in 2009

One of the key sets of revisions proposed by the president involves reforms to the taxation of capital gains for upper-income taxpayers, which would offset the cost of extension and expansion of tax preferences for middle and lower-income taxpayers.

The highest tax on capital gains would be increased from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property generally would be treated as a sale of the property. Thus, the donor or deceased owner of an appreciated asset would be subject to capital gains tax on the excess of the asset’s fair market value on the date of the transfer over the transferor’s basis. The proposal provides a \$100,000 per-person exclusion for gains realized by reason of death, and it would continue the current law exclusion for principal residences. Relief would also be provided to lessen the immediate impact of the proposed change on the transfers of small businesses. These changes would raise about \$208 billion over 10 years.

Revenue from imposition of new taxes on upper-income taxpayers would be used in part to offset tax preferences to middle and lower-income taxpayers, such as:

- Increasing the maximum child and dependent care credit
- Permanently extending increased refundability of the child tax credit
- Expanding and making permanent the earned income tax credit
- Creating a new \$500 “second earner” tax credit
- Permanently extending the American opportunity tax credit

## Tax Reform

As in prior years, this year’s budget reserves revenues for long-term revenue-neutral business tax reform. Specifically, the president calls for immediate action on business tax reform that satisfies five goals:

1. Cut the corporate tax rate and pay for it by making structural reforms and eliminating loopholes and subsidies

2. Strengthen American manufacturing and innovation
3. Strengthen the international tax system
4. Simplify and cut taxes for small businesses, and
5. Avoid adding to deficits in the short term or the long term

The amount of revenue reserved for rate reduction is slightly more than \$141 billion over a 10-year period. By way of reference, the amount of revenue required in the *Tax Reform Act of 2014*—proposed by the former Chairman of the House Ways and Means Committee, Dave Camp—to reduce the corporate rate to 25% was \$680 billion over a 10-year period. That figure does not include the cost of rate reductions for non-corporate businesses and is further reduced by a five-year phase-in of the lower rate. Thus, the FY 2016 budget proposals are best viewed as a “down payment” toward business tax reform rather than a complete tax reform proposal itself. Likely, this need for additional revenue is where the reference to “addressing-accelerated depreciation” and “reducing the tax preference for debt financed investment” are likely to be considered.

### **Treasury’s explanation**

The Treasury Department on February 2 released an accompanying explanation of the tax proposals of the budget—Treasury’s [Green Book](#) [PDF 1.57 MB]—which describes those proposals in greater detail.

\*General Explanation of the Administration’s Fiscal Year 2016 Revenue Proposals or “Green Book”

\$ = U.S. dollar

% = percent

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## **ADJUSTMENTS TO THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT (BBEDCA) BASELINE**

### **Permanently extend increased refundability of the child tax credit**

Under current law, individual taxpayers can claim a \$1,000 tax credit for each qualifying child. A qualifying child must satisfy criteria as to: (1) relationship to taxpayer; (2) residence with the taxpayer; (3) support, in that the child has not provided more than half of his or her own support; and (4) age, in that the child must be under the age of 17 years. The child must also be a U.S. citizen, national or resident.

The child tax credit is partially refundable under current law, meaning that the credit can be claimed by working taxpayers who have no individual income tax liability. The threshold amount of earned income used to calculate the refundable amount was reduced from \$10,000 to \$3,000 (thus increasing the refundable amount) for tax years 2009 through 2017. Thereafter, however, the threshold will revert to \$10,000, indexed for inflation after 2001.

The administration's FY 2016 proposal would make permanent the \$3,000 earned income threshold, and this amount would not be indexed for inflation. The purpose of this proposal is to provide additional relief to low-income working families by removing the indexation requirement, which would otherwise prevent an increasing number of such families from qualifying for this relief each year (because the income of low-income taxpayers has failed to keep pace with inflation).

This change would be effective for tax years beginning after December 31, 2017.

### **Permanently extend earned income tax credit (EITC) for larger families and married couples**

The administration's FY 2016 proposal would increase the availability of the EITC by: (1) permanently extending the EITC for larger families and married couples; (2) expanding the EITC for workers without qualifying children; and (3) simplifying the rules for claiming the EITC for workers without qualifying children.

The EITC is a refundable credit targeted towards low and moderate-income working taxpayers. The amount of EITC is based on the number of qualifying children in the taxpayer's household, the taxpayer's levels of adjusted gross income and earned income, and the taxpayer's filing status.

Under current law, the phase-in rate (at which each additional dollar of earned income results in a larger credit) for families with three or more qualifying children is set at 45% for tax years through 2017, but would thereafter revert to 40%. In addition, the phase-out range (where each additional dollar of income results in a smaller credit) for married

couples is \$5,000 above the level for unmarried taxpayers for tax years through 2017 but would revert thereafter to \$3,000 above the level for unmarried taxpayers.

The administration's FY 2016 proposal would permanently fix the level for the phase-out range for married couples at \$5,000 above that for unmarried taxpayers and would permanently fix the phase-in rate for families with three or more children at 45%.

These changes would be effective for tax years after December 31, 2017.

In addition, the administration's FY 2016 proposal would increase the EITC for workers without qualifying children by doubling the phase-in and phase-out rates for such individuals from 7.65% to 15.3%, thereby doubling maximum credit from approximately \$500 to approximately \$1,000. The age range of individuals eligible to claim the EITC for workers without qualifying children would be expanded from 25-65 years to 21-67 years. For married taxpayers filing jointly, the credit could be claimed if either spouse falls within the age range.

Finally, the administration's FY 2016 proposal would simplify the rules for claiming the EITC for workers without qualifying children. Under current law, certain taxpayers with low wages who do not have any qualifying children may still be eligible to claim the EITC in a smaller amount than for workers with qualifying children. However, such taxpayers would be allowed no EITC if they reside with a qualifying child whom they do not claim as a qualifying child (because, for example, the child is claimed by another individual in the household).

The administration's FY 2016 proposal would allow otherwise eligible taxpayers to claim the EITC when such taxpayers reside with children whom they do not claim.

This proposal would be effective for tax years after December 31, 2015.

### **Permanently extend the American opportunity tax credit (AOTC)**

The AOTC was introduced to replace the Hope scholarship credit for tax years 2009 through 2017. Under current law, the AOTC would expire for tax years after 2017 and the Hope scholarship credit would again become effective for such tax years.

The AOTC can be claimed for 100% of the first \$2,000 of qualified tuition and related expenses and 25% of the next \$2,000 of such expenses, for a total maximum credit of \$2,500 per student per year. The AOTC is phased out for married taxpayers filing jointly with adjusted gross income between \$160,000 and \$180,000 (\$80,000 and \$90,000 for all other taxpayers.)

The AOTC is available for the first four years of college whereas the Hope scholarship credit was only available for the first two years. In addition, the AOTC has a higher phase-out range (making it available to taxpayers with higher incomes) and is partially

refundable (providing a benefit to low-income families without sufficient income tax liability.)

The administration's FY 2016 proposal would make the AOTC a permanent replacement for the Hope scholarship credit. This change would be effective for tax years after December 31, 2017.

## **RESERVE FOR BUSINESS TAX REFORM THAT IS REVENUE NEUTRAL IN THE LONG RUN**

### **REFORM THE U.S. INTERNATIONAL TAX SYSTEM**

#### **Restrict deductions for excessive interest of members of financial reporting groups**

The administration's FY 2016 proposal to restrict deductions for excessive interest of members of financial reporting groups is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for tax years beginning after December 31, 2015. Additionally, when a U.S. member of a U.S. subgroup owns stock of one or more foreign corporations, this proposal would apply before the administration's minimum tax proposal discussed above.

#### **KPMG observation**

Unlike the proposals discussed above, which are focused primarily on the foreign activities of U.S. multinationals, this proposal appears principally intended to limit foreign-owned multinationals from disproportionately claiming interest expense against their U.S. income tax liability as compared to their tax liabilities elsewhere in the world.

#### **Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas**

The administration's FY 2016 proposal would create a new general business credit against income tax equal to 20% of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. Any creditable costs incurred by a foreign subsidiary would allow a tax credit to be claimed by the U.S. parent company.

In addition, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business

outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign company (CFC), no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a U.S. trade or business would be limited solely to expenses associated with the relocation of the trade or business and would not include capital expenditures or costs for severance pay and other assistance to displaced workers. The proposal would be effective for expenses paid or incurred after the date of enactment.

#### **KPMG observation**

Neither the tax credit nor the expense disallowance would apply unless there is an impact on U.S. jobs from the insourcing or outsourcing, respectively, of a U.S. trade or business. The budget proposal does not specify the required degree of such impact or ways to determine it. The proposal also does not specify the extent to which there must be a simultaneous impact on the foreign trade or business (and jobs).

#### **Repeal delay in the implementation of worldwide interest allocation**

The administration's FY 2016 budget includes a new proposal that would accelerate the availability of the worldwide affiliated group election for allocating interest expense to tax years beginning after December 31, 2015. The Green Book states that accelerating the availability of the election would allow taxpayers to more accurately allocate and apportion interest expense for all purposes for which the allocation is relevant, including for implementing the new minimum tax proposal discussed below.

#### **Make permanent the exception under subpart F for active financing income**

The administration's FY 2016 budget includes a new proposal that would make permanent the temporary active financing exception to subpart F income for certain insurance, banking, financing, and similar income.

#### **KPMG observation**

Although deferral would no longer be available, by extending this exception, active financing income would benefit from the 19% reduced U.S. rate described above rather than being subjected to (28%) U.S. residual tax at the full corporate rate.



## **Extend the look-through treatment of payments between related controlled foreign corporations (CFCs)**

The administration's FY 2016 budget includes a new proposal that would make permanent the temporary subpart F "look-through" exception for certain payments between related CFCs.

### **KPMG observation**

Like the extension for active financing income, when taken together with the other budget proposals, this proposal would allow income to qualify for a lower U.S. rate.

## **Impose a 19% minimum tax on foreign income**

The administration's FY 2016 budget includes a new proposal that would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). The minimum tax would apply to a U.S. corporation that is a U.S. shareholder of a CFC or that has foreign earnings from a branch or from the performance of services outside the United States. Under the proposal, a foreign branch of a U.S. corporation would be treated like a CFC. The foreign earnings subject to the proposal would be subject to current U.S. taxation at a rate of 19% less 85% of the per-country foreign effective tax rate (the "residual minimum tax rate").

The foreign effective tax rate would be computed on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country for the 60-month period that ends on the last day of the domestic corporation's or CFC's tax year, as applicable. For this purpose, the foreign taxes taken into account are those taxes that generally would be eligible to be claimed as a foreign tax credit during the 60-month period. The foreign earnings taken into account for the 60-month period generally would be determined under U.S. tax principles but would include disregarded payments deductible elsewhere, such as interest or royalty payments among related CFCs, and would exclude dividends from related parties.

The country to which a CFC's foreign earnings and associated foreign taxes are assigned is based on the CFC's tax residence under foreign law, but the earnings and taxes of a particular CFC may be allocated to multiple countries if the earnings are subject to tax in multiple countries. If the same earnings of a CFC are subject to tax in multiple countries, the earnings and all of the foreign taxes associated with those earnings would be assigned to the highest-tax country.

The minimum tax for a particular country would be computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's minimum tax base for a country for a tax year would be the total amount of foreign earnings for the tax year assigned to that country, reduced by an allowance for

corporate equity (ACE). The ACE provision would provide a risk-free return on equity invested in active assets and is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

For purposes of determining the foreign effective tax rate and the minimum tax base for a particular year, the proposal would include special rules to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for U.S. tax purposes without triggering tax in the high-tax country. For example, no deduction would be recognized for a payment from a low-tax country to a high-tax country that would be treated as a dividend eligible for a participation exemption in the high-tax country. In addition, the earnings assigned to a low-tax country would be increased for a dividend payment from a high-tax country that is treated as deductible in the high-tax country.

The minimum tax would be imposed on current earnings regardless of whether they are repatriated to the United States. The subpart F regime generally would continue to require a U.S. shareholder of a CFC to currently include in gross income its pro rata share of the CFC's subpart F income, but the proposal would make several modifications to the existing subpart F rules as applied to U.S. corporate shareholders, including: (1) making the subpart F "high-tax" exception mandatory; (2) repealing rules regarding CFC investments in U.S. property; and (3) repealing rules regarding previously taxed earnings.

Additionally, a U.S. shareholder would not be subject to U.S. tax on gain on the sale of CFC stock to the extent the gain is attributable to the CFC's undistributed earnings. However, any gain in the stock that is attributable to unrealized gain in the CFC's assets would be subject to U.S. tax in the same manner as the future earnings from those assets (i.e., stock gain would be subject to the minimum tax or to the full U.S. rate to the extent the assets that would generate earnings are subject to the minimum tax or subpart F, respectively).

The proposal also would modify the foreign tax credit rules to prevent a U.S. corporate shareholder from offsetting its U.S. tax liability on low-taxed foreign income with foreign taxes attributable to earnings of a high-taxed CFC that were exempt from U.S. taxation.

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

The Secretary would be granted authority to issue regulations to carry out the purposes of the minimum tax, including regulations addressing the taxation of undistributed earnings when a U.S. corporation owns an interest in a foreign corporation that has a

change in CFC status, and regulations to prevent the avoidance of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Impose a 14% one-time tax on previously untaxed foreign income**

The administration's FY 2016 budget includes a new proposal that would impose a one-time 14% tax on a CFC's accumulated earnings that were not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such untaxed earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate rate for 2015. Any untaxed CFC earnings subject to this one-time tax could then be repatriated without any additional U.S. tax liability. The tax due under this proposal would be payable ratably over five years. This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning before January 1, 2016.

#### **KPMG observation**

The computational details of this proposal have not been provided. For example, it is not clear whether or to what extent deficits in one CFC might offset earnings in another CFC for this purpose, or how the taxes paid by a CFC will be taken into account if the CFC has a deficit in earnings and profits.

### **Limit shifting of income through intangible property transfers**

The administration's FY 2016 proposal to limit shifting of income through intangible property transfers is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for tax years beginning after December 31, 2015.

### **Disallow the deduction for excess non-taxed reinsurance premiums paid to affiliates**

The administration's FY 2016 proposal would: (1) deny an insurance company a deduction for reinsurance premiums for property and casualty risks paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium

and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes.

For foreign tax credit purposes, reinsurance income that is treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The provision would be effective for policies issued in tax years beginning after December 31, 2015.

### **KPMG observation**

Similar proposals have been made in the last four budget proposals. The FY 2016 proposal, like the FY 2015 proposal, would limit the disallowance to property and casualty reinsurance premiums, making it consistent with the Camp tax reform bill (February 2014).

### **Modify tax rules for dual capacity taxpayers**

The administration's FY 2016 proposal to modify the tax rules for dual-capacity taxpayers is substantially similar to the provision included in the administration's FY 2015 budget, except it generally would be effective for tax years beginning after December 31, 2015.

### **Tax gain from the sale of a partnership interest on look-through basis**

The administration's FY 2016 proposal to tax gain from the sale of a partnership interest as effectively connected income on a look-through basis is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for sales or exchanges after December 31, 2015. Very generally, the proposal would provide that gain or loss from the sale or exchange of a partnership interest would be effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss attributable to ECI property

### **Modify sections 338(h)(16) and 902 to limit credits when non-double taxation exists**

The administration's FY 2016 proposal—substantially similar to the provisions included in the administration's FY 2015 budget, except it would be effective for transactions occurring after December 31, 2015—would extend the application of section 338(h)(16) to any covered asset acquisition (within the meaning of section 901(m)) and remove foreign taxes from a section 902 corporation's foreign tax pool in the event of a transaction that results in the reduction, allocation, or elimination of a foreign

corporation's earnings and profits other than by reason of a dividend or a section 381 transaction.

### **Close loopholes under subpart F**

The administration's FY 2016 proposals to create a new category of subpart F income for digital income and to expand the foreign base company sales income rules to include income related to manufacturing services arrangements are substantially similar to provisions in the administration's FY 2015 budget, except that they would be effective for tax years beginning after December 31, 2015.

The administration's FY 2016 proposal includes two new provisions that would modify the thresholds for applying subpart F in two ways. First, for purposes of determining whether a foreign corporation is a CFC and a U.S. person is a U.S. shareholder of a CFC, the proposal would amend the ownership attribution rules of section 958(b) to attribute stock of a foreign corporation from a foreign person to a related U.S. person. However, the pro rata share of a CFC's subpart F income that a U.S. shareholder is required to include in gross income would continue to be determined based on direct or indirect ownership of the CFC, without application of section 958(b).

Second, the administration's proposal would eliminate the requirement for a foreign corporation to be a CFC for an uninterrupted period of at least 30 days in order for a U.S. shareholder to be required to include in gross income its pro rata share of the CFC's subpart F income.

Both proposals would be effective for tax years beginning after December 31, 2015.

### **Restrict the use of hybrid arrangements that create stateless income**

The administration's FY 2016 proposal to grant the Treasury Secretary authority to issue regulations denying deductions for interest and royalty payments made to related parties under certain circumstances involving a hybrid arrangement is substantially similar to the provision in the administration's FY 2015 budget, except the FY 2016 proposal would be effective for tax years beginning after December 31, 2015.

The administration's FY 2016 proposal to make sections 954(c)(3) (the "same-country exception") and 954(c)(6) (the related CFC look-through rule) inapplicable to payments made to a foreign reverse hybrid held directly by a U.S. person when such amounts are treated as deductible payments received from foreign related persons is substantially similar to the provision in the administration's FY 2015 budget, except that the FY 2016 proposal would be effective for tax years beginning after December 31, 2015.

## **KPMG observation**

The administration's proposals effectively would divide foreign income into three categories: (1) foreign income that is subject to current taxation at the full U.S. tax rate under subpart F; (2) non-subpart F income that is subject to current U.S. taxation under the minimum tax provision, and thus may bear an effective tax rate as high as 19%; and (3) non-subpart F income that is exempt from U.S. taxation pursuant to the ACE allowance, which could possibly be completely tax-free on a world-wide basis. The per-country minimum tax computation and the high-tax exception would operate to assign discrete blocks of income into these three categories with little opportunity for taxpayers to average tax rates on their operations (or on subpart F vs. active income) in different countries to their benefit.

The minimum tax coupled with the ACE allowance is conceptually similar to the minimum tax proposal in the Camp tax reform bill. Very generally, the Camp tax reform bill would have imposed a minimum tax of 15% on a CFC's foreign earnings by creating a new category of subpart F income (foreign base company intangible income or FBCII) for foreign earnings subject to an effective tax rate below 15%. Like the administration's ACE, the Camp tax reform bill excluded from the FBCII tax base a specified percentage (in the Camp tax reform bill, 10%) of the CFC's qualified business asset investment, which was defined by Camp as the aggregate adjusted basis of certain tangible depreciable property used in the CFC's trade or business. It is not clear how the ACE allowance would be determined under the administration's minimum tax provision.

The minimum tax proposal also includes several new concepts and raises a number of questions. For example, rather than allowing a foreign tax credit, the tentative U.S. minimum tax of 19% would be reduced by an average tax rate computed over a 60-month period. The administration did not provide its rationale for this rolling average approach, which generally would be similar in results to a five-year carryforward (and no carryback) for foreign tax credits in a per country basket (subject to a 15% reduction).

The proposal also would amend the rules in section 1248 regarding the sale of CFC stock by certain U.S. shareholders. As discussed above, the proposal would currently tax gain in CFC stock that is attributable to unrealized gain in the CFC's assets to the extent the assets would give rise to subpart F income or income subject to the minimum tax. It is not clear, however, how this rule would apply if the U.S. shareholder acquired the CFC's stock without making a section 338(g) election, or if the gain is attributable to appreciation that occurred while the foreign corporation was not a CFC.

## **Limit the ability of domestic entities to expatriate**

The proposal would broaden the definition of an inversion transaction by replacing the 80% test in section 7874 with a greater than 50% test, and it would eliminate the 60%

test. The proposal would also provide that an inversion transaction would occur—regardless of the level of shareholder continuity—if:

- Immediately prior to the transaction, the fair market value of the domestic entity's stock is greater than the fair market value of the foreign acquiring corporation's stock,
- The foreign acquiring corporation's expanded affiliated group is primarily managed and controlled in the United States, and
- The foreign acquiring corporation's expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

Accordingly, an inversion transaction could occur under the proposal even if a majority of the domestic entity's historic shareholders elect to maintain their existing investments in the domestic entity and not roll into foreign acquiring corporation stock.

The proposal would also expand the scope of section 7874 to provide that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the:

- Assets of a domestic corporation or domestic partnership,
- Trade or business assets of a domestic corporation or domestic partnership, or
- U.S. trade or business assets of a foreign partnership.

Finally, the proposal would provide the IRS with the authority to share tax return information with other federal agencies to facilitate the administration of an agency's anti-inversion rules. Other federal agencies that receive this information would be subject to the safeguarding and recordkeeping requirements of section 6103.

The proposals to limit a domestic entity's ability to expatriate would be effective for transactions completed after December 31, 2015. The proposal to allow the IRS to share tax return information with other federal agencies would be effective January 1, 2016, without regard to when the inversion occurred.

#### **KPMG observation**

The proposal is intended to limit the ability of domestic entities to expatriate. Under the proposal, the anti-inversion rules could apply if the continuing ownership of the domestic corporation's historical shareholders in the foreign acquiring corporation is more than 50%, and in such case the foreign acquiring corporation would be treated as a domestic corporation. Under the current anti-inversion rules in section 7874, the foreign acquiring corporation may be treated as a domestic corporation only if the continuing ownership is at least 80% (and in case the continuing ownership is at least 60% but less than 80%, other adverse but less severe tax consequences may apply). Thus, the proposed anti-

inversion rules would be triggered at a lower threshold and with more severe consequences.

This proposed change is intended to address the fact that domestic entities have been combining with smaller foreign entities resulting in a continued ownership being less than 80% (although more than 60%). Treasury stated “[t]he adverse tax consequences under current law of 60-percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base.”

Additionally, under the proposal, a foreign corporation’s acquisition of a domestic entity could be treated as an inversion—even if there is no ownership continuity—if (1) immediately prior to the transaction, the domestic entity’s fair market value is greater than the foreign acquiring corporation’s fair market value, and (2) the foreign acquiring corporation’s expanded affiliated group (A) is primarily managed and controlled in the United States, and (B) does not conduct substantial business activities in the foreign acquiring corporation’s country of creation or organization. Treasury stated that, under these circumstances, the transaction would still be considered an inversion, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group.

Section 7874 currently only applies to direct or indirect acquisitions of (1) substantially all the properties directly or indirectly held by a domestic corporation, or (2) substantially all the properties constituting a trade or business of a domestic partnership. The proposed changes to the scope of acquisitions covered by section 7874 are important in several respects. First, an inversion could occur where a foreign corporation acquires substantially all of a domestic corporation’s trade or business assets, even though such assets do not represent substantially all of the domestic corporation’s total assets (e.g., if the domestic entity retains a significant amount of cash). Second, an inversion could occur where a foreign corporation acquires substantially all the assets of a domestic partnership regardless of whether the assets constitute a trade or business. Thus, the proposal would treat acquisitions of domestic corporations and domestic partnerships similarly, as opposed to the current section 7874 acquisition rules. Finally, an inversion could occur where a foreign corporation acquires substantially all of the U.S. trade or business assets of a foreign partnership—a clear departure from current law, which does not apply to foreign entities.

Finally, the proposal would permit the IRS to share tax return information with other federal agencies to promote any agency’s anti-inversion rules. Currently, the IRS is restricted from sharing this information under section 6013.

Although not part of the inversion proposal, the proposed modifications to section 958(b) and the definition of a CFC (discussed above) could have a significant impact on



foreign-parented groups that include a U.S. corporation with its own foreign subsidiaries, including companies that have successfully “inverted” in the past.

## **SIMPLIFICATION AND TAX RELIEF FOR SMALL BUSINESS**

### **Expand and permanently extend increased expensing for small business**

The administration’s FY 2016 proposal would make permanent the 2014 increased expensing and investment limitations under section 179. Section 179 provides that, in place of capitalization and depreciation, taxpayers may elect to deduct a limited amount of the cost of qualifying depreciable property placed in service during a tax year. For qualifying property placed in service during the 2010 through 2014 tax years, the maximum deduction amount had been \$500,000, and this level was reduced by the amount that a taxpayer’s qualifying investment exceeded \$2 million. For qualifying property placed in service in tax years beginning after 2014, the limits have reverted to pre-2003 law, with \$25,000 as the maximum deduction and \$200,000 as the beginning of the phase-out range.

The FY 2016 proposal would extend the increased expensing and investment limitations of \$500,000 and \$2 million, respectively, for qualifying property placed in service in tax years beginning after 2014. The proposal would increase the expensing limitation to \$1 million for qualifying property placed in service in tax years beginning after 2015, reduced by the amount that a taxpayer’s qualifying investment exceeded \$2 million (but not below zero). These limits, and the cap on sports utility vehicles, would be indexed for inflation for all tax years beginning after 2016. In addition, qualifying property would permanently include off-the-shelf computer software, but would not include real property. An election under section 179 would be revocable with respect to any property, but such revocation, once made, would be irrevocable.

### **Expand simplified accounting for small business and establish a uniform definition of small business for accounting methods**

Certain businesses are not allowed to use the cash accounting method and must use an accrual method of accounting. These entities include C corporations, partnerships with a C corporation as a partner, and certain tax shelters. Nonetheless, “qualified personal service corporations” and certain small C corporations (generally those with \$5 million or less in average annual gross receipts for the prior three tax years, or \$1 million or less for farms) are permitted to use the cash method.

Taxpayers generally must capitalize costs incurred in the production of real or personal property and in the production or purchase of inventory. The uniform capitalization (UNICAP) rules require that these capitalized costs include both direct costs and an allocable portion of indirect costs. The UNICAP rules do not apply to a taxpayer acquiring personal property for resale if the taxpayer had \$10 million or less in average annual gross receipts for the three preceding tax years, and certain producers having

\$200,000 or less of indirect costs in a tax year. Exceptions from the UNICAP rules also apply to certain specified property and expenses, including animals and certain plants produced in a farming business, and inventory items of certain qualifying small business taxpayers.

A taxpayer must account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business, and an accrual method of accounting must be used with regard to purchases and sales whenever inventory accounting is necessary. Certain types of qualifying small taxpayers with inventories may use the cash method of accounting, and may deduct the cost of items purchased for resale and of raw materials purchased for use in producing finished goods in the year the related merchandise is sold, or, if later, in the year in which the taxpayer actually pays for the items: (1) any taxpayer (other than a tax shelter) with average annual gross receipts of \$1 million or less for the three preceding tax years, and (2) a taxpayer (other than a farming business) that would not be prohibited from using the cash method under the rules described above and that had \$10 million or less in average annual gross receipts. In general, a taxpayer in this second group qualifies only if its business activity is not classified as mining, manufacturing, wholesale or retail trade, or an information industry activity.

The administration's FY 2016 proposal would create a uniform small business threshold at \$25 million in average annual gross receipts for the prior three tax years allowing exceptions from certain accounting rules (with adjustments for taxpayers not having sufficient receipts history, and all entities treated as a single employer being treated as a single entity for purposes of the test). Satisfaction of the gross receipts test would allow an entity to elect one or more of the following items: (1) use of the cash method of accounting in lieu of an accrual method (regardless of whether the entity holds inventories); (2) the non-application of the uniform capitalization (UNICAP) rules; and (3) the use of an inventory method of accounting that either conforms to the taxpayer's financial accounting method or is otherwise properly reflective of income, such as deducting the cost of inventory items in the year the related merchandise is sold.

A business whose average annual gross receipts exceeds the threshold would not be able to make an election to use one or more simplified accounting methods for the current tax year and the following four tax years. These rules would supersede the special cash method exception rules that apply to farm corporations, but exceptions allowing the cash method by personal service corporations and by business entities that are not C corporations (other than partnerships with a C corporate partner), regardless of size, would continue. Any tax shelter would continue to be required to use an accrual accounting method. The exceptions from UNICAP that are not based on a gross receipts test would continue. The UNICAP farming exceptions would not be changed, but would be affected by the new gross receipts threshold for excepting UNICAP requirements altogether for produced property, as well as the higher threshold for requiring use of an accrual accounting method.

The provision would apply to tax years beginning after December 31, 2015, and the threshold would be indexed for inflation with respect to tax years beginning after December 31, 2016.

The administration believes that a uniform definition of small business for determining applicable accounting rules and a consistent application of a gross receipts test would simplify tax administration and taxpayer compliance, that increasing the threshold amount of average annual gross receipts to \$25 million would increase the number of business entities that would be able to obtain relief from complex tax accounting rules, and that indexing the threshold for inflation ensures that the small business definition remains a current reflection of the appropriate level of gross receipts qualifying for the exceptions.

### **Eliminate capital gains taxation on investments in small business stock**

The administration's FY 2016 proposal would make permanent a complete exclusion from income to a non-corporate taxpayer for gain from a sale or exchange of qualified small business stock that is held for at least five years. Under current law, the exclusion is 100% for qualified stock that is acquired after September 27, 2010, through December 31, 2014, and it will drop to 50% for stock acquired after that. Generally, a portion of the excluded gain is a preference item included in computing alternative minimum tax (AMT). However, for stock subject to the 100% exclusion, the excluded gain is not an AMT preference item.

Qualified small business stock is generally stock acquired at its original issue from a C corporation whose:

- Aggregate gross assets, through the time of issue, do not exceed \$50 million
- Business constitutes an active trade or business (other than certain disqualified activities) during substantially all of the taxpayer's (acquirer's) holding period

The gain from any small business stock sale that a taxpayer can take into account in computing the exclusion may not exceed \$10 million in total and, in any one year, may not exceed 10 times the adjusted basis of the qualified stock the taxpayer disposes of in the year.

The FY 2016 proposal to permanently adopt the complete exclusion would be effective for stock acquired after December 31, 2014. The proposal would also eliminate the AMT preference item for gain excluded under the provision and impose additional reporting requirements.

Also, under current law, a non-corporate taxpayer may elect to defer recognition of gain on any qualified small business stock held more than six months (and that is not otherwise excluded from income) if the proceeds are reinvested in new qualified stock

within 60 days. The administration's FY 2016 proposal would extend this time limit to six months for qualified small business stock the taxpayer has held longer than three years.

### **Increase the limitations for deductible new business expenditures and consolidate provisions for start-up and organizational expenditures**

The *Creating Small Business Jobs Act of 2010* increased the limit on deductible start-up expenditures, but only for tax years beginning in 2010. The administration's FY 2016 proposal would increase the limitations on a permanent basis and consolidate the provisions for start-up and organizational expenditures, effective for tax years beginning after 2015.

Start-up expenditures under section 195 consist of any amount (other than interest, taxes, or research and experimental expenditures) that would be deductible if paid or incurred in connection with the operation of an existing active trade or business, but that is instead incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

Organizational expenditures under sections 248 and 709 are expenditures that are incident to the creation of a corporation or partnership, chargeable to a capital account, and are of a character that, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

Apart from the exception for tax years beginning in 2010, current law permits taxpayers to deduct up to \$5,000 of start-up expenditures in the tax year in which the active trade or business begins (with the amount reduced by the amount by which such expenses exceed \$50,000) and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins. The 2010 legislation increased the amounts of this rule from \$5,000 to \$10,000 and from \$50,000 to \$60,000, but only for a single tax year beginning in 2010.

Similarly, current law permits taxpayers to deduct up to \$5,000 of organizational expenditures in the tax year in which the corporation or partnership begins business (with the amount reduced by the amount by which such expenses exceed \$50,000) and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the corporation or partnership begins business.

The administration's FY 2016 proposal would permanently allow up to \$20,000 of new business expenditures to be deducted in the tax year in which a trade or business begins (with the amount reduced by the amount by which such expenses exceed \$120,000) and the remaining amount to be amortized ratably over the 180-month period beginning with the month in which the business begins. New business expenditures

would include amounts incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business; and (4) expenditures that are incident to the creation of an entity taxed as a corporation or partnership, that are chargeable to a capital account and are of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

The administration believes that a permanent doubling of currently deductible start-up expenses would support new business formation and job creation, and consolidating the provisions relating to expenditures incurred by new businesses would simplify tax administration and reduce new business owners' tax compliance burden.

### **Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance**

The *Affordable Care Act of 2010* created a tax credit designed to help small employers provide health insurance for their employees and their employees' families. To qualify for the credit, an employer must make uniform contributions of at least 50% of the premium. A qualified employer is one with no more than 25 full-time equivalent employees during the tax year and whose employees have annual full-time equivalent wages that average no more than \$50,000 (indexed for inflation beginning in 2014.)

The credit is phased out on a sliding scale for employers with between 10 and 25 full-time equivalent employees, and also for average annual employee wages between \$25,000 and \$50,000 (these amounts are indexed for inflation.)

The administration's FY 2016 proposal would expand the group of employers that are eligible for the credit to include employers with up to 50 full-time equivalent employees, and would begin the phase-out at 20 full-time equivalent employees. In addition, the coordination of the phase-outs between the number of employees and the average wage would be amended to provide for a more gradual combined phase-out. The proposal also would eliminate a requirement that the employer make a uniform contribution on behalf of each employee, and eliminate the limit imposed by the rating area average premium.

The provision would be effective for tax years beginning after December 31, 2014.

## **INCENTIVES FOR MANUFACTURING, RESEARCH, AND CLEAN ENERGY**

### **Enhance and make permanent research incentives**

The research credit has always been a temporary provision, and it expired for research expenses paid or incurred after December 31, 2014. It has been extended 16 times previously.

The administration's FY 2016 proposal would make the research credit permanent. The traditional credit method would be eliminated for amounts paid or incurred after December 31, 2015. Other changes would also apply after 2015. The rate of the alternative simplified credit would be raised to 18% from 14%; there would be no special rate for start-up companies. Additional types of contract expenses would be allowed a 75% qualified research expense. Individual owners of partnerships and S corporations would be allowed to use the credits generated by the entity regardless of the income generated by the entity.

The research credit would be allowed against alternative minimum tax (AMT). For individuals, the requirement to amortize research expenses over 10 years for AMT purposes would be eliminated.

#### **KPMG observation**

Prior administration proposals have supported a permanent research credit, but would have retained the traditional credit method. The substantive changes, especially allowing the credit against AMT, would likely make the credit much more attractive to many taxpayers.

### **Extend and modify certain employment tax credits, including incentives for hiring veterans**

The administration's FY 2016 proposal would permanently extend the Work Opportunity Tax Credit (WOTC) to apply to wages paid to qualified individuals who begin work for the employer after December 31, 2014, when the current credit expired. The WOTC is currently available for employers hiring individuals from one or more of nine targeted groups (one of which is veterans).

The proposals would expand the definition of a qualified veteran, effective for individuals who begin work for the employer after December 31, 2015, to include disabled veterans who use G.I. Bill benefits to attend a qualified educational institution or training program within one year of being discharged or released from active duty, if they are hired within six months of ending attendance at the qualified educational institution or training. Under this proposal, \$12,000 of their wages paid in their first year of employment would be eligible for the credit.

The proposal would also permanently extend the Indian employment credit to apply to wages paid to qualified employees in tax years beginning after December 31, 2014, when the current credit expired. In addition, the proposal would modify the calculation of the Indian employment credit. For tax years beginning after December 31, 2015, the credit would be equal to 20% of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current tax year over the average amount of such wages and costs paid or incurred by the employer in the two preceding tax years.

### **Modify and permanently extend renewable electricity production tax credit and investment tax credit**

The administration's FY 2016 proposal would expand existing federal income tax incentives for renewable energy projects.

Section 45 provides a production tax credit (PTC) for the production of electricity from wind energy at facilities that began construction prior to 2015 and also provides a PTC for the production of electricity from biomass, geothermal, trash combustion, hydropower, landfill gas, and marine and hydrokinetic facilities if construction begins on the facility prior to 2015. The PTC is available for a 10-year period beginning with the date the facility is originally placed in service. In order to claim the PTC, the electricity produced by the facility must be sold to third parties.

In addition, section 48 provides an investment tax credit (ITC) for 10% or 30% of energy credit property placed in service prior to 2017. Energy-credit property includes solar, geothermal, fuel cell, microturbine, combined heat and power, and small wind property. A 10% ITC is available for solar property placed in service after 2016. There is no expiration date for a 10% ITC for geothermal property (non-heat pump). In addition, PTC-qualifying facilities may elect to claim the ITC instead of the PTC, but only for PTC-qualifying facilities that began construction by their PTC mandated deadline (i.e., construction must begin before 2015).

The administration's FY 2016 proposal would extend the current law PTC for facilities on which construction begins before 2016. For facilities on which construction begins after December 31, 2015, the proposal would permanently extend the PTC and make it refundable. The proposal would also eliminate the third-party sales requirement, making the PTC available in cases where the electricity is consumed directly by the producer, to the extent that production can be independently verified.

A PTC would be allowed for residential energy efficient property installed in a dwelling unit; the current credit for energy efficient property would expire at the end of 2016.

Solar facilities that currently qualify for the ITC would be eligible for the PTC in lieu of the ITC for construction that begins after 2015.

The FY 2016 proposal would make the ITC permanent. It would also make permanent the election to use the ITC, rather than the PTC, for facilities for which production is allowed the PTC

### **KPMG observation**

By making the PTC refundable, the proposal would lessen the need for renewable energy developers to obtain tax-equity financing. Tax-equity financing is a form of equity financing whereby a renewable energy developer seeks an outside investor that can efficiently utilize the tax attributes. In a tax-equity transaction, the credits are specially allocated to the outside investor through the use of a partnership flip transaction.

The elimination of the third-party sales requirement would make the PTC more valuable for technologies such as solar and open-loop biomass, the electricity from which is most often consumed on-site.

Previous administrative proposals would have repealed the ITC.

### **Modify and permanently extend the deduction for energy-efficient commercial building property**

Section 179D provides a deduction in an amount equal to the cost of “energy efficient commercial building property” placed in service during the tax year. The section 179D deduction expired on December 31, 2014.

The proposal would extend the current law for property placed in service before January 1, 2016, and update it to apply Standard 90.1-2004.

For facilities placed in service after December 31, 2015, the proposal would permanently extend and modify the current deduction with a larger fixed deduction. The proposal would raise the current maximum deduction for energy-efficient commercial building property to \$3.00 per square foot (from \$1.80 per square foot). The maximum partial deduction allowed with respect to each separate building system would be increased to \$1.00 per square foot (from \$0.60 per square foot).

For taxpayers that simultaneously satisfy the energy savings targets for both building envelope and heating, cooling, ventilation, and hot water systems, the proposal would increase the maximum partial deduction to \$2.00 per square foot (from \$1.20 per square foot). Energy-savings targets would be updated every three years by the Secretary of Treasury in consultation with the Secretary of Energy to encourage innovation by the commercial building industry.

A deduction would also be allowed, beginning in 2016, for projected energy savings from retrofitting existing commercial buildings with at least 10 years of occupancy.



A taxpayer could only take one deduction for each commercial building property.

### **KPMG observation**

By increasing the basic deduction from \$1.80 to \$3.00, the proposal would substantially enhance the incentive for taxpayers.

### **Provide a carbon dioxide investment and sequestration tax credit**

Current law allows a tax credit to taxpayers that sequester carbon dioxide (CO<sub>2</sub>) emissions. The credit is equal to \$20 per metric ton if the CO<sub>2</sub> is properly stored and \$10 per ton if it is used as a tertiary injectant in an enhanced oil or natural gas recovery project. The credit is available through the tax year in which an aggregate of 75 million tons has been sequestered. The credit is indexed for inflation.

To facilitate technological advances that will assist in controlling future greenhouse gas emissions, the administration's FY 2016 budget proposes a new refundable investment tax credit for up to 30% of the installed cost of transportation and storage infrastructure to be used in CO<sub>2</sub> sequestration at certain electric generating units. Apparently, the credit would be available to generating units that capture more than 75% of their CO<sub>2</sub> emissions. Both new and retrofitted units would be eligible; a retrofitted unit would need to have a capacity greater than 250 megawatts and capture and store more than 1 million metric tons of CO<sub>2</sub> a year.

The investment tax credit would be allocated to applicants, based on numerous specified factors, for all or part of their qualified investment. A total of \$2 billion of credits would be available. At least 70% of the credits would be required to flow to projects fueled by greater than 75% coal. Applications would be due 18 months after the date of enactment, and the allocations would occur after that.

The proposal would also provide a new, refundable sequestration credit, \$10 per metric ton of CO<sub>2</sub> if permanently sequestered and beneficially used, such as in an enhanced oil recovery operation, and \$50 per metric ton if permanently sequestered and not beneficially reused. The credit would be allowed for a maximum of 20 years of production. The rate would be indexed for inflation.

The proposal would be effective after the date of enactment.

### **Provide additional tax credits for investment in qualified property used in a qualifying advanced energy manufacturing project**

The administration's FY 2016 proposal would extend the qualified advanced energy property (QAEP) credit.

The QAEP credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind and other renewable energy component property, electric grids, carbon dioxide capture and sequestration property, plug-in electric vehicles and component parts, etc. QAEP credits were first enacted as part of the *American Recovery and Reinvestment Act of 2009*, and \$2.3 billion in QAEP credits were originally authorized. All of the credits were allocated by Treasury in two separate allocation rounds.

The administration's FY 2016 proposal would authorize an additional \$2.5 billion of QAEP credits. Up to \$200 million of the credits may be allocated to the construction of infrastructure that contributes to networks of refueling stations that serve alternative fuel vehicles. Under the proposal, taxpayers would be allowed to apply for a credit with respect to either all or only **a part of** the qualified investment in the project. If a taxpayer applies for a credit with respect to only a portion of its qualified investment, the taxpayer's increased cost sharing and the reduced cost to the government would be taken into account in the allocation process.

The proposal would be effective as of the date of enactment.

### **Provide new manufacturing communities tax credit**

The administration's FY 2016 proposal would create a new allocated tax credit to support investments in communities that have suffered a major job loss event. For this purpose, a major job loss event occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit, resulting in a long-term mass layoff. Applicants for the credit would be required to consult with relevant state or local economic development agencies (or similar entities) in selecting those investments that qualify for the credit. The administration proposes to work with Congress on many details of the credit, and indicates that the credit could be structured using the mechanism of the new markets tax credit or as an allocated investment credit similar to the qualifying advanced energy project credit. The proposal would provide about \$2 billion in credits for qualified investments approved in each of the three years, 2016 through 2018.

### **Extend the tax credit for cellulosic biofuels**

The administration's FY 2016 proposal would extend the tax credit for cellulosic biofuels producers.

Section 40 provides a \$1.01 per gallon tax credit for the production of cellulosic biofuels, however, the credit expired on December 31, 2014.

The proposal would retroactively extend the credit from January 1, 2015, through December 31, 2020. Beginning in 2021, the amount of the credit would be reduced by

20.2 cents per gallon in each subsequent year, so that the credit would expire after December 31, 2024.

## **INCENTIVES TO PROMOTE REGIONAL GROWTH**

### **Modify and permanently extend the new markets tax credit (NMTC)**

The NMTC is a credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE), held for a period of seven years. The allowable credit totals 39% of the amount paid to the CDE for the investment at its original issue, and it is apportioned over the seven-year period after the purchase (5% for each of the first three years, 6% for each of the remaining four years). The credit may be recaptured if the entity ceases to be a qualified CDE during this seven-year period, if the proceeds of the investment cease to be used as required, or if the equity investment is redeemed. Only a specific dollar amount of QEIs can be designated each year; the NMTC expired on December 31, 2014.

The administration's FY 2016 proposal would make the NMTC permanent, with an allocation amount of \$5 billion for each year, and would permit NMTC amounts resulting from QEIs made after December 31, 2014, to offset alternative minimum tax (AMT) liability. The proposal would be effective upon enactment.

### **Reform and expand the low-income housing tax credit (LIHTC)**

For private activity bonds (PABs) to be tax-exempt (i.e., to be "qualified private activity bonds"), the face amount of PABs issued by the issuing authority in any state must not exceed the maximum amount of such bonds that the authority may issue for the year ("PAB volume cap"). Under the Code, a state is allowed a limited amount of PAB volume cap per year.

Also, each year, a state is provided with a limited amount of low-income housing tax credits (LIHTCs) for the state to allocate among proposed low-income housing projects. Often, states are faced with more proposed low-income housing projects than their LIHTC allocation can support. Increasing the amount of LIHTCs could allow deserving projects that would not otherwise be viable to obtain the LIHTC needed to go forward.

#### *Allow conversion of private activity bond (PAB) volume cap into LIHTCs*

The administration's FY 2016 proposal would provide two ways in which the PAB volume cap could be converted into LIHTCs.

First, states would be allowed to convert an annual maximum PAB volume cap into LIHTC allocations for the same year. The conversion ratio would be reset each calendar year to respond to changing interest rates. For each \$1,000 of PAB volume cap

surrendered, the state would receive additional allocable LIHTCs equal to:  $\$1000 \times$  twice the applicable percentage that applies for PAB-financed buildings (30% present value applicable percentage) based upon the appropriate percentages as of December of the preceding calendar year. The aggregate amount of PAB volume cap that a state may convert with respect to a calendar year is 18% of its PAB volume cap for that year. The proposal would be effective for PAB volume cap received in, and additional LIHTC allocation authority received for calendar years beginning after the date of enactment.

Second, a taxpayer would be able to qualify for the 30% present value LIHTC—generally allowed for projects at least 50% financed with tax exempt bonds—without actually getting such financing if there is an allocation of PAB volume cap in the required amount of financing. Such allocation would reduce the state's remaining volume cap as if tax-exempt bonds had been issued. The proposal would be effective for projects that are allocated volume cap after the date of enactment.

*Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income*

An investor in low-income rental housing can qualify for a low-income housing tax credit (LIHTC), generally for the first 10 years in which the housing project is in service, if the building meets various requirements. Currently, a taxpayer may elect between two criteria for a building: (1) at least 20% of the units must be rent restricted and occupied by tenants with income at or below 50% of area median income (AMI); or (2) at least 40% of the units must be rent restricted and occupied by tenants with incomes at or below 60% of AMI.

The administration's FY 2016 proposal would add a third elective criterion to qualify a building for the LIHTC. Under this new criterion, at least 40% of the units would have to be occupied by tenants with incomes that average no more than 60% of AMI. At the election of the owner, a special rule would apply for income qualification for tenants in HUD or the Department of Agriculture subsidized units. These proposals would be effective for elections made after the date of enactment.

*Change formulas for 70% PV and 30% PV LIHTCs*

The owner of rental housing occupied by tenants having incomes below specified levels may claim the LIHTC over a 10-year period. The credits earned each year generally depend on, among other things, a credit rate, called the "applicable percentage." There are two applicable percentages—the 70% present value credit rate and the 30% present value credit rate. The applicable percentage is generally set monthly, for credit allocations made in that month, and applies to the future LIHTCs related to that allocation. There has been a statutorily set temporary minimum applicable percentage of 9% for the 70% present value credit rate. This minimum 9% rate expired for credit allocations made before January 1, 2014.

The administration's FY 2016 proposal would not extend the 9% temporary minimum applicable percentage, but would increase the discount rate used in the present value calculation for allocated LIHTCs. The change would apply to both 70% and 30% LIHTCs. Under the proposal, the discount rate to be used would be the average of the mid-term and long-term applicable federal rates for the relevant month, plus 200 basis points (although the 30% present value credit rate for LIHTCs that result from tax-exempt bond financing would continue to be computed under current law). The proposal would be effective for buildings that receive allocations on or after the date of enactment.

*Add preservation of federally assisted affordable housing to allocation criteria*

Under current law, each state must adopt a qualified allocation plan (QAP) to guide the allocation of LIHTCs. The Code requires 10 selection criteria to be included in every plan. The administration's FY 2016 proposal would add preservation of federally assisted affordable housing as an eleventh selection criterion that QAPs must include. The proposal would be effective for allocations made in calendar years beginning after the date of enactment.

*Remove the qualified census tracts (QCT) population cap*

LIHTC projects located in qualified census tracts (QCTs) receive a "basis boost" of up to 30% of their eligible basis thus increasing the owner's LIHTCs by 30%. A QCT is designated by the Department of Housing and Urban Development (HUD). The combined aggregate population of census tracts in a metropolitan statistical area (MSA) designated as QCTs cannot exceed 20% of population of the MSA.

The administration's FY 2016 proposal would allow HUD to designate as a QCT any census tract that meets the current statutory criteria of a poverty rate of at least 25% or 50% or more of households with an income less than 60% of AMI. That is, the proposal would remove the current limit under which the aggregate population in census tracts designated as QCTs cannot exceed 20% of the metropolitan area's population. This proposal would apply to buildings that receive allocations of LIHTCs or volume cap after the date of enactment.

*Implement requirement that LIHTC-supported housing protect victims of domestic abuse*

The administration's FY 2016 proposal would require protections for victims of domestic abuse to be included in the "long-term use agreement" that is entered between the owner of a low-income housing project and the state housing credit agency.

In addition, the proposal would clarify that occupancy restrictions or preferences that favor persons who have experienced domestic abuse would qualify for the "special needs" exception to the general public use requirement.

The proposed change would be effective for agreements that are either first executed, or subsequently modified, 30 days or more after enactment. The proposed clarification of the general public use requirement would be effective for tax years ending after the date of enactment.

## **INCENTIVES FOR INVESTMENT IN INFRASTRUCTURE**

### **Provide America Fast Forward Bonds and expand eligible uses**

The proposed America Fast Forward Bond (AFFB) program is similar to the administration's FY 2014 proposal for making permanent the Build America Bond (BAB) program. Under the BAB program, the federal subsidy level for refund payments processed on or after October 1, 2014, and on or before September 30, 2015, has been reduced by a sequestration rate of 7.3%. The proposed AFFB program would provide direct payments to state and local governmental issuers in an amount equal to 28% of the coupon interest, a federal subsidy level that is intended to be approximately revenue neutral relative to the estimated future federal tax expenditures for tax-exempt bonds. Further, the proposal also recommends that the AFFB program be protected from sequestration.

In addition to containing all the eligible uses that the BAB program contained, the proposed AFFB program would provide another eligible use: financing for the types of projects and programs that can be financed with qualified private activity bonds, subject to the applicable state bond volume caps for the qualified private activity bond category. The proposal would be effective for bonds issued on or after January 1, 2016.

### **Allow current refundings of state and local governmental bonds**

With respect to tax-exempt bonds issued by state and local governments, a "current refunding" or "current refunding issue" refers to bonds issued to refinance another outstanding bond issue in circumstances when the outstanding bonds are redeemed or retired within 90 days after issuance of the current refunding bonds. Typically, state and local governments engage in current refunding transactions primarily to reduce interest costs.

Currently, the extent to which statutory provisions address current refunding varies among different state and local bond provisions. In order to promote greater uniformity and increased certainty, the administration's FY 2016 proposal would set forth a general Code provision to authorize current refunding of state or local bonds upon satisfaction of certain requirements related to the size and maturity of the bonds. The provision would generally apply to state and local bond programs that do not otherwise allow current refunding or expressly address the treatment of current refunding. It would not affect refunding of bonds when current refundings are already allowed.

The proposal would be effective as of the date of enactment.

### **Provide a new category of qualified private activity bonds for infrastructure projects referred to as “Qualified Public Infrastructure Bonds”**

The administration proposes to create a new category of tax-exempt qualified private activity bonds called “Qualified Public Infrastructure Bonds” (QPIBs). These bonds would be eligible to finance certain specific categories of infrastructure projects that are permitted to be financed with exempt facility bonds under current law. The proposal would impose two core eligibility requirements for QPIBs: the projects financed by QPIBs must be owned by a state or local governmental unit, and they must meet a public use requirement by serving a general public use or being available on a regular basis for general public use. Further, the proposal would require that, in general, QPIBs meet the existing eligibility restrictions for qualified private activity bonds.

The proposal would make the bond volume cap requirement and the AMT preference for interest on specified private activity bonds inapplicable to QPIBs.

The proposal would remove those existing categories of exempt facilities that overlap with QPIBs effective upon the effective date of the proposal, subject to a transitional exception for qualified highway or surface freight transfer facilities.

The proposal would be effective for bonds issued starting January 1, 2016.

### **Modify qualified private activity bonds for public educational facilities**

Current law permits tax-exempt private activity bond financing for “qualified public educational facilities.” A private “corporation” must own the public school facilities and must transfer the ownership of the school facilities to the public agency at the end of the term of the bonds for no additional consideration. In addition, a special separate annual volume cap applies to these bonds.

The proposal would eliminate the private corporation ownership requirement and would allow any private person either to own the public school facilities, or to operate those school facilities through lease, concession, or other operating arrangements. The proposal also would remove the requirement to transfer the school facilities to a public agency. Further, it would remove the separate volume cap for qualified public educational facilities; these facilities instead would be included under the unified annual state bond volume cap for private activity bonds under section 146.

The proposal would be effective for bonds issued after the date of enactment.

## **Modify treatment of banks investing in tax-exempt bonds**

Banks, thrift institutions, and other financial institutions generally may not deduct any portion of their interest expenses allocable to tax-exempt obligations acquired after August 7, 1986. Financial institutions, however, generally can deduct 80% of their interest expenses allocable to tax-exempt interest on qualified tax-exempt obligations. Qualified tax-exempt obligations include certain tax-exempt obligations issued by issuers that issue no more than \$10 million of certain tax-exempt bonds annually (the qualified small issuer limit).

The *American Recovery and Reinvestment Act of 2009* (ARRA) provided a temporary rule that generally allowed financial institutions to deduct 80% of interest expense allocable to any tax-exempt bond issued in 2009 or 2010, regardless of whether the bond was a qualified tax-exempt obligation. However, the bonds that benefited from this temporary rule could not exceed 2% of the financial institution's total assets. In addition, for obligations issued during 2009 and 2010, the ARRA made several modifications to the definition of qualified small issuer, including an increase in the annual issuance limit to \$30 million.

The administration proposes to permanently expand the qualified small issuer limit to permit such issuers to issue up to \$30 million of tax-exempt bonds annually. In addition, the amended qualified small issuer exception would not be limited to 2% of a financial institution's assets. This increase would allow financial institutions to deduct 80% of interest expenses allocable to qualifying bonds of these issuers. In addition, beginning with bonds issued in 2016, the proposal would permanently allow financial institutions to deduct 80% of interest expense allocable to any tax-exempt bond, regardless of whether the bond is a qualified tax-exempt obligation. This exception would continue to be limited to 2% of the taxpayer's assets. Finally, the same rules that are applicable to C corporation financial institutions would also be applied to financial institutions that are S corporations or qualified subchapter S subsidiaries.

The proposal would apply to bonds issued in calendar years beginning on or after January 1, 2016.

### **KPMG observation**

This proposal would expand the bonds subject to the more favorable interest disallowance rules in section 291, but still preserve differences in treatment of different bonds. This proposal would only apply to tax-exempt bonds issued in 2016 or later. Bonds issued before 2008 or from 2011 to 2015 would continue to be subject to the current rules for interest disallowance, even if held in 2016 or in later years. Additionally, this proposal would continue to maintain slightly different treatment for qualified tax-exempt obligations and other tax-exempt obligations, primarily the 2% limit.



The proposal also would not reinstate all of the ARRA provisions on tax-exempt obligations. Importantly, this proposal would not reinstate the ARRA provision that treated section 501(c)(3) organizations as separate issuers in certain cases for purposes of determining whether a bond was a qualified tax-exempt obligation. There is no indication as to why this provision was omitted.

The proposal would also provide for different treatment than under the Seventh Circuit decision in *Vainisi v. Commissioner*, 599 F.3d 567 (7th Cir. 2010), *rev'g* 132 T.C. 1 (2009). This decision allowed S corporations and qualified subchapter S subsidiaries to stop applying the 20% disallowance rule after three years. The proposal would apply the same 20% disallowance rules to S corporations and qualified subchapter S subsidiaries that would apply to C corporations.

### **Repeal tax-exempt bond financing of professional sports facilities**

State and local bonds are classified as either governmental bonds or private activity bonds. The exclusion from income for state and local bond interest does not apply to private activity bonds issued to finance professional sports facilities. Bonds generally are classified as private activity bonds under a two-part test if: (1) more than 10% of the bond proceeds are used for private business use (private business use test); and (2) the debt service on more than 10% of the bond proceeds is payable or secured from property or payments derived from private business use (private payments test). Thus, if debt service is paid from sources other than sports facility revenues or other private payments, current law permits the use of tax-exempt governmental bond proceeds for professional sports facilities.

The proposal eliminates the private payments test for professional sports facilities. As a result, bonds issued to finance professional sports facilities would be taxable private activity bonds if more than 10% of the facility is used for private business use. By removing the private payment test, tax-exempt governmental bond financing of sports facilities with significant private business use by professional sports teams would be eliminated.

The proposal would be effective for bonds issued after December 31, 2015.

### **Modify tax-exempt bonds for Indian tribal governments**

Section 7871(c) generally restricts the authority of Indian tribal governments to issue tax-exempt bonds by limiting them to the financing of “essential governmental function” activities that are “customarily” performed by state and local governments with general taxing powers. The ARRA provided \$2 billion in bond authority for a new category of Indian tribal government tax-exempt bonds known as “Tribal Economic Development Bonds.” This authority, in section 7871(f), generally permits use of tax-exempt bond financing under standards that are comparable to those applied to state and local governments. ARRA also directed Treasury to study the Tribal Economic Development

Bond provisions and report recommendations. Treasury issued its report in December 2011. The proposal follows the recommendations.

Under the administration's proposal, Indian tribal governments would be permitted to issue governmental bonds and private activity bonds under standards comparable to those applicable to state and local governments. The proposal would retain the existing location restriction, which generally requires that financed projects be located on Indian reservations. It would also retain the prohibition on financing certain gaming projects.

The provision would be effective as of the date of enactment.

### **Other bond proposals**

The administration's FY 2016 budget also contains several bond proposals intended to provide incentives for investment in infrastructure, including private investment, and to repeal certain existing incentives. These are:

- Repeal the \$150 million non-hospital bond limitation on qualified section 501(c)(3) bonds
- Increase national limitation amount for qualified highway or surface freight transfer facility bonds from \$15 billion to \$19 billion
- Allow more flexible research arrangements for purpose of the private business use limitations
- Simplify arbitrage investment restrictions for tax-exempt bonds
- Simplify single-family housing mortgage bond targeting requirements

### **Exempt foreign pension funds from the application of the Foreign Investment in Real Property Tax Act (FIRPTA)**

The administration's FY 2016 proposal to exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests (USRPIs) is substantially similar to the provision included in the administration's FY 2015 budget, except it would be effective for dispositions occurring after December 31, 2015

### **ELIMINATE FOSSIL FUEL TAX PREFERENCES**

#### **Eliminate Fossil Fuel Tax Preferences**

The administration's FY 2016 proposal would repeal several preferences currently available to the oil and gas sector because "[t]he President agreed at the G-20 Summit in Pittsburgh to phase out fossil fuels":

### *Repeal fossil fuel qualified income for publicly traded partnerships*

Section 7704 provides that certain partnerships may be publicly traded entities while maintaining passthrough status. These entities are thus exempted from the corporate tax.

To qualify for this exemption, 90% or more of the gross income of the partnership must be qualifying income. Qualifying income generally includes income derived from (among other sources) the exploration, development, mining or production, processing, refining, transportation (including pipelines), or marketing (other than at retail to an end user) of certain fossil fuels.

The administration's FY 2016 budget introduces a new proposal that would repeal the exemption from corporate tax for publicly traded partnerships (PTPs) that derive qualifying income from activities relating to fossil fuels. The proposal would be effective after December 31, 2020.

### *Other*

A number of other fossil-fuel related proposals have been carried over from previous budgets and appear to be unchanged (except for effective dates), including:

- Repeal the section 43 enhanced oil recovery credit
- Repeal the section 45I credit for qualified crude oil and natural gas production from a marginal well
- Repeal the section 263(c) expensing of intangible drilling costs
- Repeal the section 193 deduction for tertiary injectants
- Repeal the section 469(c)(3) exception to passive loss limitation for working interests in oil and natural gas properties
- Repeal percentage depletion for oil and natural gas wells
- Repeal the section 199 domestic manufacturing deduction for oil and natural gas and coal and other hard mineral fossil fuels
- Increase geological and geophysical amortization period for independent producers to seven years under section 167(h)
- Repeal expensing of mining exploration and development costs
- Repeal percentage depletion for hard mineral fossil fuels
- Repeal capital gains treatment for coal and lignite royalties

The repeal of these additional items would generally be effective after December 31, 2015.

## **KPMG observation**

When the PTP provisions were originally enacted, fossil fuels were included in the qualified income exception to the treatment of PTPs as C corporations because that industry had traditionally used partnership entities. Fossil fuel related PTPs are approximately 85% of all qualified PTPs currently treated as partnerships.

Notably, the Camp tax reform bill last Congress also included narrowing the scope of the PTP rules. However, the Camp tax reform bill would have required financial services PTPs to be classified as corporations, but would have allowed fossil fuel PTPs to maintain passthrough status.

Elsewhere, the FY 2016 Budget contains a proposal to limit the amount of capital gain deferred under the like-kind exchange rules on an exchange of real property to \$1 million per taxpayer per tax year. While not specifically a fossil fuel provision, this limitation on like-kind exchanges of real property could have a substantial negative impact on some natural resource conservation measures, often required by local law. Natural resource property is defined by section 614. Specifically, section 614(b)(3) treats properties participating in a unitization or pooling agreement as a single property. Unitizations and poolings are conservation techniques that prevent producers who own tracts of land over a larger pool of minerals from rushing to produce reserves (law of capture) from that pool of minerals and often reducing the total recovery of reserves.

For federal income tax purposes the term “unitization or pooling agreement” means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis, and the owners also agree to share in production on a stipulated percentage or fractional basis regardless of which interest or interests the oil or gas is produced from. In addition, when one person owns all of the operating mineral interests in several leases, an agreement with its several royalty owners to determine the royalties payable to each on a stipulated percentage basis (regardless of which lease(s) oil or gas is produced) is also considered to be a unitization or pooling agreement. No formal cross-conveyance of properties is necessary.

Rev. Rul. 68-186, 1968-1 C.B. 354 noted that:

The position that a unitization effects an exchange was confirmed by the amendment to section 614 of the Internal Revenue Code of 1954 made by the Revenue Act of 1964. Section 614(b)(3) of the Code; H. Rept. No. 749, C.B. 1964-1 (Part 2), 125, at 216; S. Rept. No. 830, C.B. 1964-1 (Part 2), 505, at 622. The exchange of working interests qualifies, as does the exchange of equipment, under section 1031 of the Code as property held for productive use in a trade or business or for investment which is exchanged solely for property of a like kind to be held for use in a trade or business or for investment.

On some federal offshore properties, the producers cannot enter a unit without first drilling a producing well. This causes a series of unit enlargements (e.g., up to 12 enlargements of the same unit), each of which is treated as a section 1031 exchange. Treating unitizations and poolings (including communalizations formed pursuant to 30 U.S.C. § 226(m); 43 C.F.R. § 3105.2-2) as taxable events would run counter to their conservation nature causing substantial unwarranted tax bills.

## **REFORM THE TREATMENT OF FINANCIAL AND INSURANCE INDUSTRY PRODUCTS**

### **Require that Derivative Contracts be Marked to Market with Resulting Gain or Loss Treated as Ordinary**

The timing and character of gain or loss on derivative contracts may vary under current law depending on how the contracts are classified or traded. For example, gain or loss with respect to a forward contract is generally recognized only when the contract is transferred or settled and is generally capital if the contract is a capital asset in the hands of the taxpayer. Certain futures contracts, in contrast, must be marked to market with capital gain or loss treated as 60% long-term and 40% short-term. Furthermore, certain options that are otherwise similar may be subject to disparate tax treatment depending on whether they are entered into over-the-counter or traded on certain exchanges.

Similar to the administration's FY 2015 proposal, the administration's FY 2016 proposal would generally require that a "derivative contract," as defined in the proposal, be marked to market annually (no later than the last business day of a taxpayer's tax year). Gain or loss would be recognized for tax purposes and would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law. The proposal would also eliminate or amend a number of other provisions of the Code that address specific taxpayers and transactions, including section 475 (mark to market for securities dealers), section 1256 (mark to market and 60/40 capital treatment), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sale transactions), and section 1260 (constructive ownership transactions).

The proposal would define a "derivative contract" broadly to include any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property. An embedded derivative contract would also be subject to mark to market if the derivative itself would be. Thus, contingent debt or structured notes linked to actively traded property would be taxed as derivative contracts under the proposal.

In addition, actively traded stock that would not otherwise be subject to mark to market under the proposal would be required to be marked to market if it is part of a straddle transaction with a derivative contract (i.e., a derivative contract that substantially diminishes the risk of loss on the actively traded stock). Under such circumstances, pre-existing gain on the financial instrument would be recognized at the time of the mark, and loss would be recognized when such loss would have been recognized on the stock in the absence of the straddle.

The proposal would also provide the Secretary with the authority to issue regulations matching the timing, source, and character of income, gain, deduction, and loss from a capital asset and a transaction that diminishes the risk of loss or opportunity for gain from that asset. As an example, the proposal provides the following example:

For example, in the case of stock issued by a U.S. corporation, the source of dividends on the stock would be U.S., while gain or loss on a sale of the stock is generally sourced based on the residence of the recipient. Thus, if a taxpayer were to hedge the stock with a notional principal contract (NPC), the Secretary would have the authority to write regulations that provide that dividend equivalent payments on the NPC are matched to the dividends on the stock for timing, source, and character, while gain or loss on the NPC could be matched to the gain or loss on the stock for timing, source, and character.

The proposal would not, however, apply mark-to-market treatment to a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer's trade or business primarily to manage risk of certain price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. The proposal provides that the identification requirement would be met if the transaction is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligations.

The proposal would apply to derivative contracts entered into after December 31, 2015.

#### **KPMG observation**

The administration's FY 2016 proposal imposes mark-to-market treatment on derivative contracts only when the value of the derivative contract is determined, directly or indirectly, in whole or in part, by the value of actively traded property. Although the administration's FY 2016 proposal would provide a framework for more uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative contract and thus be

subject to mark-to-market treatment. Several details would need to be clarified, such as what constitutes actively traded property and what is an embedded derivative.

### **Modify rules that apply to sales of life insurance contracts**

The administration's FY 2016 proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The proposal also would modify the transfer-for-value rule so that certain exceptions to that rule would not apply to buyers of policies, i.e., by eliminating the existing exception to transfer-for-value for sales of policies to a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. The exception to the transfer-for-value rule would continue to apply to transfers to the insured, and would apply also to transfers to a partnership or corporation that is at least 20% owned by the insured.

The provision would apply to sales or assignments of interests in life insurance policies and payments of death benefits in tax years beginning after December 31, 2015.

### **KPMG observation**

This provision was designed to address life settlement transactions. The proposal would impose reporting burdens on both purchasers of life insurance contracts and on life insurance companies that pay death benefits. The requirement for the insurance company to provide an "estimate" of a policy purchaser's basis in the contract being reported on is problematic.

This provision was included in the administration's 2012 through 2015 revenue proposals.

### **Modify Proration Rules for Life Insurance Company General and Separate Accounts**

The administration's FY 2016 proposal would change the existing regime for prorating investment income between the "company's share" and the "policyholders' share" for purposes of the dividends-received deduction (DRD). Instead of keying off the policyholders' and company's shares of net investment income, under the proposal the

policyholders' share would equal the ratio of an account's mean reserves to mean assets and the company's share would equal one less the policyholders' share.

The provision would be effective for tax years beginning after December 31, 2015.

#### **KPMG observation**

Separate account DRD provisions have been included in the administration's FY 2012 through FY 2015 revenue proposals. The FY 2016 proposal is consistent with the proposal in the Camp tax reform bill. The proposal would in effect eliminate the separate account DRD for most life insurance companies that issue variable life insurance and variable annuity products.

#### **Expand pro rata interest expense disallowance for corporate-owned life insurance (COLI)**

The administration's FY 2016 proposal would repeal the section 264(f)(4)(A)(ii) exception from the overall section 264(f) pro rata interest expense disallowance rule for life insurance, annuity, and endowment contracts covering employees, officers, or directors of a business that is the owner or beneficiary of the contracts. The proposal would leave intact the section 264(f)(4)(A)(i) exception for contracts covering 20% owners of the business that owns the contract.

The proposal would apply to contracts issued after December 31, 2015, in tax years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would cause the contract to be treated as a new contract, except in the case of a master contract, for which the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

#### **KPMG observation**

This provision, which diminishes the attractiveness of purchasing corporate owned life insurance (COLI), was included in the administration's FY 2011 through FY 2015 revenue proposals.

#### **Conform net operating loss rules of life insurance companies to those of other corporations**

The administration's FY 2016 proposal would replace the section 810 three-year carryback and 15-year carryforward rule for a life insurance company's losses from operations with the section 172 net operating loss rules applicable to other corporations, allowing instead a two-year carryback and a 20-year carryforward.

The provision would be effective for tax years beginning after December 31, 2015.



## **KPMG observation**

This new provision is consistent with the proposal outlined in the Camp tax reform bill (February 2014). If enacted the proposal would have a significant impact on a life insurance company's deferred tax asset (DTA) admissibility computations for statutory accounting purposes.

## **OTHER REVENUE CHANGES AND LOOPHOLE CLOSERS**

### **Repeal last-in, first-out (LIFO) method of accounting for inventories**

Under current law, taxpayers may determine inventory values using the LIFO method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. To use the LIFO method for tax purposes, a taxpayer also must use LIFO for financial reporting (LIFO conformity rule).

For a taxpayer facing rising inventory prices, the LIFO method can provide a tax benefit through lower ending inventories, leading to higher cost of goods sold deductions and lower taxable income. To the extent prices continue rising and the taxpayer acquires or manufactures more goods than it sells during the year, the taxpayer accumulates incremental layers of goods valued at current-year costs, which provide for the deferral of income tax to the extent such costs increase.

The administration's FY 2016 proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2015. Taxpayers would be required to change their method of inventory accounting, resulting in the inclusion of income of prior years' LIFO reserves (the amount deferred under the LIFO method). The resulting section 481(a) adjustment, which is a one-time increase in gross income, would be taken into account ratably over 10 tax years beginning with the year of change.

### **Repeal lower-of-cost-or-market (LCM) inventory accounting method**

Certain taxpayers are permitted to use the lower-of-cost-or-market (LCM) method, under which the taxpayer may write down the carrying values of eligible inventories to replacement or reproduction cost. A taxpayer also may write down the cost of subnormal (damaged) goods to reflect their decline in value.

The administration's FY 2016 proposal would repeal the use of the LCM and subnormal goods methods for the tax years beginning after December 31, 2015. Wash sale rules would prevent taxpayers from circumventing the prohibition. Compliance with these changes would be treated as a change in method of accounting for inventories, and any resulting section 481(a) adjustment would be included in gross income ratably over a four-year period beginning with the year of change.

### **KPMG observation**

Repeal of LCM and subnormal goods writedowns would leave inventory (for tax purposes) at cost, including adjustments necessary under the uniform capitalization rules.

### **Modify like-kind exchange rules for real property and collectibles**

Current law provides that no gain or loss is recognized when business or investment property is exchanged for “like-kind” business or investment property.

The administration believes there is little justification for allowing deferral of the capital gain on the exchange of real property (as opposed to personal property used in a trade or business, such as machinery and equipment). Among other things, the ability to exchange unimproved real estate for improved real estate encourages “permanent deferral” by allowing taxpayers to continue a cycle of tax deferred exchanges, with potentially no tax ever being imposed on increased value of the disposed properties.

As was the case for the previous fiscal year’s budget proposal, the administration’s FY 2016 proposal would limit the amount of capital gain deferred under these rules from the exchange of real property to \$1 million (indexed for inflation) per taxpayer per tax year. It would not affect the treatment of exchanges of personal property. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The proposal would be effective for like-kind exchanges completed after December 31, 2015.

### **KPMG observation**

The Camp tax reform bill proposed repealing section 1031 entirely. Thus, there appears to be an increased focus on section 1031, both by the administration and by key lawmakers.

### **Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft**

Under current depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years, and the recovery period for airplanes and other assets (including ground property, but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

Effective for property placed in service after December 31, 2015, the administration’s FY 2016 proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Under the proposal, general aviation

passenger aircraft would include any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations). Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.)—as well as all helicopters—would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

### **Expand the definition of substantial built-in loss for purposes of partnership loss transfers**

Under current law, if there is a transfer of a partnership interest, the partnership is required to adjust the basis of its assets with respect to the transferee partner if the partnership at that time has a substantial built-in loss in its assets, i.e., if the partnership's adjusted basis in its assets exceeds the fair market value of its assets by more than \$250,000. This rule is intended to prevent the duplication of losses.

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would extend the mandatory basis adjustment rules for transfers of partnership interests to require an adjustment with respect to the transferee partner if such partner would be allocated a net loss in excess of \$250,000 if the partnership were to sell its assets for cash for fair market value in a fully taxable transaction immediately after the transfer. This adjustment would be required even if the partnership as a whole did not have a substantial built-in loss.

The Joint Committee on Taxation (JCT) provided an example of when the provision could apply in its description of a substantially similar budget proposal for FY 2013. In that example, a partnership has two assets, one of which (Asset X) has a built-in gain of \$1 million and the other of which (Asset Y) has a built-in loss of \$900,000. The partnership has three taxable partners—A, B, and C. The partnership agreement specially allocates to A any gain on sale or exchange of Asset X; the partners share equally in other partnership items. Although the partnership does not have an overall built-in loss, B and C each have a net built-in loss of \$300,000 allocable to their partnership interest (one-third of the loss attributable to Asset Y). If C were to sell the partnership interest to another person (D), the proposal would require a mandatory basis adjustment with respect to D. The JCT explanation notes that, if an adjustment were not made, the purpose of the current mandatory basis adjustment rules for built-in losses arguably would not be carried out.

The provision would apply to sales or exchanges after the date of enactment

## **Extend partnership basis limitation rules to nondeductible expenditures**

Under current law, a partner's distributive share of partnership losses for a tax year is allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership tax year. Losses that are disallowed under this rule generally are carried forward and are allowed as deductions in future tax years to the extent the partner has sufficient basis at such time. The IRS issued a private letter ruling in 1984 concluding that this loss limitation rule does not apply to limit a partner's deduction for its share of the partnership's charitable contributions.

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would modify the statutory loss limitation rule to provide that a partner's distributive share of expenditures not deductible by the partnership (or chargeable to capital account) are allowed only to the extent of the partner's adjusted basis in the partnership interest at the end of the year.

A JCT explanation of a substantially similar budget proposal for FY 2013 indicates that the current loss limitation rule is intended to limit a taxpayer's deductions to its investment in the partnership (taking into account its share of partnership debt). The JCT explanation suggests that the administration's proposal is intended to address the following concern:

Because of a technical flaw in the statute, which was written in 1954, it appears that the limitation does not apply, for example, to charitable contributions and foreign taxes of the partnership, because those items are not deductible in computing partnership income. Because a partner's basis cannot be decreased below zero, a partner with no basis is allowed a deduction (or credit) for these items without having to make the corresponding reduction in the basis of his partnership interest that would otherwise be required.

The provision would apply to partnership tax years beginning on or after the date of enactment.

## **Limit the Importation of Losses under Related Party Loss Limitation Rules**

Generally, a loss cannot be recognized if it is from a sale or exchange of property between either certain related persons, including an individual and a more-than-50% owned corporation or partnership, or two corporations or partnerships in which the individual has a more-than-50% ownership. However, section 267(d) allows the transferee to apply that loss against any gain on a later disposition of the transferred asset.

The administration's FY 2016 proposal would amend section 267(d) so that the transferee could not apply such a loss to the later transaction to the extent that gain or loss with respect to such property is not subject to U.S. federal income tax in the hands

of the transferor immediately before the transfer, but any gain or loss with respect to such property is subject to U.S. federal income tax in the hands of the transferee immediately after the transfer. This would appear to apply, among other situations, when the transferor is a foreign person not subject to U.S. federal income tax and the related transferee is a person subject to U.S. federal income tax.

The provision would apply to transfers made after the date of enactment.

### **KPMG observation**

This proposal also appeared in the administration's FY 2013, FY 2014, and FY 2015 proposals. It represents a continuing effort to police the importation of built-in losses. The Joint Committee of Taxation's description of this provision in the administration's FY 2013 proposal notes that it "addresses certain transactions in which a taxpayer might utilize a sale or exchange that does not qualify as a tax free organization or reorganization to accomplish a loss importation result, under similar circumstances with respect to the taxation or nontaxation of gain or loss as are addressed in section 362(e)(1)."

### **Deny deduction for punitive damages**

A taxpayer may not deduct a fine or similar penalty paid to the government for the violation of law. If a taxpayer is convicted of a violation of the antitrust laws, or a taxpayer's plea of guilty or nolo contendere to a violation is entered or accepted in a criminal proceeding, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or settlement of certain antitrust civil suits. When neither provision applies, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on a trade or business, regardless of whether the damages are compensatory or punitive.

The administration's FY 2016 proposal would prohibit any deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report payments to the insured person and to the IRS.

The provision would apply to damages paid or incurred after December 31, 2015.

### **Conform corporate ownership standards**

The administration's FY 2016 proposal would amend the "control test" under section 368 to adopt the "affiliation test" under section 1504. Thus, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain

preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, “plain vanilla” preferred stock).

Currently, for tax-free transfers of assets to controlled corporations in exchange for stock, tax-free distributions of controlled corporations, and tax-free corporate reorganizations, “control” is defined in section 368 as the ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation. In contrast, the “affiliation test” under section 1504 for permitting two or more corporations to file consolidated returns is the direct or indirect ownership by a parent corporation of at least 80% of the total voting power of another corporation’s stock and at least 80% of the total value of the corporation’s stock (excluding certain plain vanilla preferred stock). Several other Code provisions cross-reference and incorporate either the control test or the affiliation test.

The proposal notes that by allocating voting power among the shares of a corporation, taxpayers can manipulate the control test in order to qualify or not qualify, as desired, a transaction as tax-free (for example, a transaction could be structured to avoid tax-free treatment to recognize a loss). In addition, the absence of a value component allows corporations to retain control of a corporation but to “sell” a significant amount of the value of the corporation tax-free. The proposal also notes that a uniform ownership test would reduce complexity currently caused by the two tests.

The proposal would be effective for transactions occurring after December 31, 2015.

#### **KPMG observation**

This proposal is consistent with previous changes made to the affiliation test. For example, as noted in the proposal, prior to 1984, the affiliation test required ownership of 80% of the voting stock and 80% of the number of shares of all other classes of stock of the corporation, similar to the control test in section 368. Congress amended the affiliation test in 1984 in response to similar concerns that corporations were filing consolidated returns under circumstances in which a parent corporation’s interest in the issuing corporation was being manipulated.

#### **Tax corporate distributions as dividends**

The administration’s FY 2016 proposal would make several changes to the tax treatment of certain distributions of property by a corporation to its shareholder which, under current law, may not give rise to dividend income. The proposal explains that transactions of this type reduce a corporation’s earnings and profits but do not result in a reduction in a corporation’s dividend paying capacity, and are therefore inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation’s dividend-paying capacity. The FY 2016 proposal targets three transactions previously identified in prior proposals and additionally includes purchases of hook stock by a corporate subsidiary.

*Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions*

Generally, a corporation is required to recognize any gain realized on the distribution of any appreciated property to a shareholder, but does not recognize any loss realized on the distribution of property with respect to its stock. Although the corporation does not recognize a loss, its earnings and profits (E&P) are decreased by the sum of the amount of money, the principal amount or issue price of any obligations (as the case may be), and the adjusted basis of any other property distributed. Additionally, if an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock.

Similar to the administration's FY 2015 proposal, the FY 2016 proposal would amend section 312(a)(3) to provide that E&P are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

*Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment*

Similar to the administration's FY 2015 proposal, the FY 2016 proposal would treat a leveraged distribution from a corporation to its shareholders that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation. This proposal revises a previous proposal to disregard a shareholder's basis in the stock of a distributing corporation for purposes of recovering such basis under section 301(c)(2).

This proposal would be effective for transactions occurring after December 31, 2015.

*Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions*

If a subsidiary corporation acquires in exchange for cash or other property stock of a direct or indirect corporate shareholder issued by that corporation (hook stock), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary's cash or other property in exchange for issuing the hook stock.

The administration's FY 2016 proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a

deemed distribution from the purchasing subsidiary (through any intervening entity) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would also grant the Secretary authority to prescribe regulations to treat purchases of interest in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2015.

#### **KPMG observation**

The FY 2016 proposal would not only create a potentially taxable dividend, but also a potential zero tax basis in the hook stock received by the subsidiary.

#### *Repeal gain limitation for dividends received in reorganization exchanges*

Section 356(a)(1) currently provides that if, as part of a reorganization, a shareholder receives stock and boot in exchange for its stock in the target corporation, then the shareholder recognizes gain, but not in excess of the boot (the so-called “boot within gain” limitation). Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the shareholder is treated as a dividend to the extent of the shareholder’s ratable share of the corporation’s E&P, with the remainder of the gain treated as gain from the exchange of property (generally capital gain).

Similar to the administration’s FY 2011 through FY 2015 proposals, the administration’s FY 2016 proposal would repeal the “boot within gain” limitation in the case of any reorganization if the exchange has the effect of the distribution of a dividend under section 356(a)(2). In addition, the FY 2016 proposal would align the available pool of E&P to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2015.

#### **KPMG observation**

The FY 2016 proposal differs from the FY 2015 proposal in that the FY 2016 proposal refers to the rules under section 316 for purposes of determining the available pool of E&P, while the FY 2015 proposal referred to “all of the available earnings and profits of the corporation.” This change may have been intended to clarify that the deemed dividend should follow normal dividend rules and not provide an E&P priority to boot dividends.



## **Repeal Federal Insurance Contributions Act (FICA) tip credit**

The administration's FY 2016 proposal would repeal the income tax credit for FICA taxes an employer pays on tips. Currently, tip income is treated as employer-provided wages subject to employment taxes under FICA. Employers are responsible for withholding and reporting the employee's portion of FICA and paying the employer's portion of FICA. An eligible employer may claim a credit against the business's income taxes for FICA taxes paid on certain tip wages.

The provision would apply for tax years beginning after December 31, 2015.

## **Repeal the Excise Tax Credit for Distilled Spirits with Flavor and Wine Additives**

Current law allows a credit against the \$13.50 per proof-gallon excise tax on distilled spirits for flavor and wine additives.

The administration's FY 2016 proposal would repeal this credit and tax all distilled spirit beverages at the \$13.50 per proof-gallon rate.

The proposal would be effective for all spirits produced in or imported into the United States after December 31, 2015.

# **BUDGET PROPOSALS**

## **TAX REFORM FOR FAMILIES AND INDIVIDUALS**

### **Reform child care tax incentives**

Under current law, a nonrefundable tax credit is allowed to certain working taxpayers for up to 35% of their child and dependent care expenses, limited to \$3,000 of eligible expenses for one child or dependent, and \$6,000 for two or more. The 35% rate decreases by one percentage point for every \$2,000 (or part thereof) of AGI over \$15,000 until the percentage reaches 20% for AGI above \$43,000.

In addition, some individuals receive dependent care assistance from their employers, either directly or through being permitted to set aside funds for child and dependent care in a flexible spending account (FSA).

The administration's FY 2016 proposal would repeal dependent care flexible spending accounts on the grounds that these are not universally offered (causing inequities between families) and can result in loss of income if the allocated amount is not spent.

In addition, the income level at which the child and dependent care credit phases down would be increased from \$15,000 to \$120,000, such that the rate would reach 20% at income above \$148,000. Taxpayers with children under age five could claim a credit of

up to 50% of expenses up to \$6,000 (or \$12,000 for two children under age five). The rate for this young child credit would phase down at a rate of one percentage point for every \$2,000 (or part thereof) of AGI over \$120,000 until the rate reaches 20% for taxpayers with AGI above \$178,000. The expense limits and phase down thresholds would be indexed for inflation after 2016.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Simplify and better target tax benefits for education**

In addition to the proposed permanent extension of the American Opportunity Tax Credit (AOTC), The administration's FY 2016 proposal would make changes to the tax benefits for education in five principal areas.

First, the administration's FY 2016 proposal would expand and modify the AOTC and repeal the lifetime learning credit (LLC). The LLC is a credit of 20% of up to \$10,000 in qualified tuition and related expenses that may be claimed for an unlimited number of years.

AOTC is currently available for the first four years of post-secondary education. Pursuant to the administration's FY 2016 proposal, the AOTC would be available for the first five years of post-secondary education and for five tax years. Students studying less than half-time would be eligible to claim a part-time AOTC equal to 50% of the first \$2,000 of eligible expenses plus 12.5% of the next \$2,000 of eligible expenses, whereas students studying at least half-time would continue to be eligible as under current law. However, students who can be claimed as a dependent on someone else's tax return would no longer be able to claim the non-refundable portion of the AOTC on their own returns.

The refundable portion of the AOTC would be increased to \$1,500 of the otherwise allowable credit for students studying at least half-time and to \$750 for students studying less than half-time. The procedure for claiming this credit would be simplified. The expense limits and the refundable portion would be indexed for inflation after 2016.

Second, Pell grants would be made excludible from income. Pell grants are post-secondary education federal grants sponsored by the U.S. Department of Education. Pell grants (like most scholarships) are excluded from gross income (and are therefore not subject to tax) to the extent they are used by students to pay for qualified tuition and related expenses. Pell grants can also be used to pay for expenses other than qualified tuition and related expenses such as room and board or other living expenses. To the extent Pell grants are used to pay for such living expenses, they are not excluded from income and are therefore subject to tax.

The administration's FY 2016 proposal would make Pell grants excludable from gross income without regard to whether they are used for qualified tuition and related

expenses or for other expenses such as living expenses. This would provide that the tax benefits a student can receive from the AOTC are not reduced by the Pell grant, and would also remove the complexity involved in trying to maximize the tax benefits from the AOTC in relation to the Pell grant.

The proposal would be effective for tax years beginning after December 31, 2015.

Third, the reporting of tuition expenses and scholarship income on Form 1098-T would be modified. The administration's FY 2016 proposal would require institutions of higher learning to report amounts received for qualified tuition and related expenses, repealing the option, as under current law, of reporting amounts billed. In addition, any entity issuing a scholarship or grant in excess of \$500 (indexed for inflation after 2016) that is not processed or administered by an institution of higher learning would be required to report the amount on Form 1098-T.

Fourth, the student loan interest deduction would be repealed and an exclusion would be provided for certain debt relief and scholarships. The administration's FY 2016 proposal would repeal the deduction for student loan interest for new students. New students would benefit instead from the expanded AOTC and from income-driven repayment options targeted at reducing the burden of student loan repayment.

The administration's FY 2016 proposal would also conform the tax treatment of loan amounts repaid by the Indian Health Service (IHS) scholarship program and the IHS loan forgiveness program to the tax treatment of loan amounts paid by the National Health Service Corps (NHSC) and certain state programs intended to increase the availability of health care services to underserved populations. In addition, the tax treatment of IHS Health Professions Scholarships would be conformed to the tax treatment of NHSC scholarships and Armed Forces Health Professions (AFHP) scholarships. Participants in the NHSC and AFHP loan and scholarship programs and certain state programs are currently eligible for beneficial exclusions not available under the IHS programs.

Fifth, the administration's FY 2016 proposal would repeal Coverdell education savings accounts (ESAs) and would reduce the federal tax benefits allowed to qualified tuition programs (QTPs), also known as 529 plans. Under current law, contributions to Coverdell ESAs and QTP plans are not deductible. Contributions to Coverdell ESAs are limited to \$2,000 per year and are subject to phase-out for taxpayers with modified adjusted gross income (AGI) between \$95,000 and \$110,000 (\$190,000 and \$220,000 for taxpayers filing a joint return). Contributions to QTPs are effectively unlimited and are not subject to income limitations. Investment earnings in both plans accrue tax free and distributions for qualified expenses are not subject to tax.

Pursuant to the administration's FY 2016 proposal, distributions of earnings from a QTP after the date of enactment would be includible in the income of the student beneficiary, but not of the account holder.

The education proposals outlined above would generally be effective for tax years beginning after December 31, 2015, except that the proposals concerning student loan forgiveness would be effective for discharges of loans after December 31, 2015, and the proposals concerning expanded disclosure of taxpayer information would be effective on enactment.

**Provide for automatic enrollment in IRAs, including a small employer tax credit, increase the tax credit for small employer plan start-up costs, and provide an additional tax credit for small employer plans newly offering auto-enrollment**

The administration's FY 2016 proposal would require employers in business for at least two years that have more than 10 employees to offer an automatic IRA option to employees. Contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsors a qualified plan, it would not be required to provide an automatic IRA. However, if the employer excluded from eligibility a portion of the workforce or class of employees, the employer would be required to offer the automatic IRA option to those excluded employees.

Small employers (those with no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable credit for expenses associated with the arrangement of up to \$1,000 per year for three years. Such employers would be entitled to an additional non-refundable credit of \$25 per enrolled employee, up to a maximum of \$250, for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (e.g., because they have 10 or fewer employees).

In addition, the "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE plan would be tripled from the current maximum of \$500 per year for three years to a maximum of \$1,500 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This credit would not apply to the automatic IRAs.

Small employers would be allowed a credit of \$500 per year for up to three years for new plans that include auto enrollment (this is in addition to the "start-up costs" credit of \$1,500 per year). Small employers would also be allowed a credit of \$500 per year for up to three years if they add auto enrollment as a feature to an existing plan.

The provision would be effective after December 31, 2016.

## **Expand penalty-free withdrawals for long-term unemployed**

The administration's FY 2016 proposal would expand the exception from the 10% additional tax for early withdrawal from a qualified retirement plan to include distributions to long-term unemployed individuals from an IRA, 401(k), or other tax-qualified defined contribution plan.

An individual would be eligible for this exception to the 10% additional tax on any distribution from an IRA, 401(k), or other tax-qualified defined contribution plan if the following conditions are met:

- (1) The individual has been unemployed for more than 26 weeks by reason of a separation from employment and has received unemployment compensation for that period,
- (2) The distribution is made during the tax year in which the unemployment compensation is paid or in the succeeding tax year
- (3) The aggregate of all such distributions does not exceed certain annual limits

The exception would apply to distributions, but such distributions may not exceed half of the aggregate fair market value of the individual's IRAs, 401(k), and other tax-qualified defined contribution plans. However, an individual would be eligible for this exception for the first \$10,000 of otherwise eligible distributions, even if that amount is greater than half the aggregate fair market value of such plan benefits.

The provision would apply to eligible distributions occurring after December 31, 2015.

## **Require retirement plans to allow long-term part-time workers to participate**

The administration's FY 2016 proposal would require section 401(k) plans to expand participation eligibility to employees who worked at least 500 hours per year, for at least three consecutive years, with the employer. The proposal would not require expanded eligibility to receive employer contributions such as matching contributions.

Employers would receive nondiscrimination testing relief from top-heavy vesting and top-heavy benefit requirements after expanding the eligibility group.

The provision would apply to plan years beginning after December 31, 2015.

## **Facilitate annuity portability**

The administration's FY 2016 proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan. The distribution would not be subject to the 10% additional tax.

The proposal would be effective for plan years beginning after December 31, 2015.

### **Simplify minimum required distribution (MRD) rules**

#### *Eliminate MRD requirements for balances of \$100,000 or less*

The administration's FY 2016 proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed \$100,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase-in ratably for individuals with aggregate retirement benefits between \$100,000 and \$110,000.

The provision would be effective for taxpayers attaining age 70½ years on or after December 31, 2015, and for taxpayers who die on or after December 31, 2015, before attaining age 70 ½ .

#### *Harmonize MRD requirements for tax-favored retirement accounts*

The administration's FY 2016 proposal would harmonize the application of the MRD requirements for holders of designated Roth accounts and Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½. Individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½.

The provision would be effective for individuals attaining age 70½ after December 31, 2015 and for taxpayers who die on or after December 31, 2015 before attaining age 70 ½ .

### **Allow all inherited plan and IRA balances to be rolled over within 60 days**

The administration's FY 2016 proposal would expand the option available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited-plan or IRA assets by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The provision would be effective for distributions after December 31, 2015.

### **Provide a Second-Earner Tax Credit**

The administration's FY 2016 proposal would introduce a credit for two-earner married couples who file jointly, effective for tax years beginning after December 31, 2015. This would be a non-refundable credit equal to a percentage of the lower earner's income

from wages or self-employment of up to \$10,000. The credit rate would be 5% and would phase down by half a percentage point for each \$10,000 of AGI over \$120,000. Thus, the maximum credit would be \$500 and it would be fully phased out at AGI over \$210,000. The maximum creditable earned income (\$10,000) and the phase-out threshold (\$120,000) would be indexed for inflation after 2016.

#### **KPMG observation**

This proposed credit for two-earner married couples would do little to mitigate the “marriage penalty” whereby two individuals with income subject to tax in the 28% bracket or higher pay more tax as a married couple than they would as two single individuals.

#### **Extend exclusion from income for cancellation of certain home mortgage debt**

Gross income generally includes income realized from the discharge of indebtedness. Under current law, an exception to this general rule exists for qualified principal residence interest (QPRI), which is acquisition indebtedness with respect to a taxpayer’s principal residence, limited to \$2 million (\$1 million if married filing separately). Pursuant to this exception, taxpayers are allowed to exclude income from the discharge of QPRI. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for QPRI relief, which applies to debt forgiven in calendar years 2007 through 2014.

The administration’s FY 2016 proposal would extend the exclusion from income for QPRI to amounts that are discharged before January 1, 2018, and to amounts that are discharged pursuant to an agreement entered into before that date.

### **REFORMS TO CAPITAL GAINS TAXATION, UPPER-INCOME TAX BENEFITS, AND THE TAXATION OF FINANCIAL INSTITUTIONS**

#### **Reduce the value of certain tax expenditures**

The administration’s FY 2016 proposal would limit the tax value of certain specified deductions and exclusions from AGI, and all itemized deductions. This limitation would reduce to 28% the value of these deductions and exclusions that would otherwise reduce taxable income in the 33%, 35%, or 39.6% tax brackets. A similar limitation would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or from pre-tax employee income, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving

expenses, contributions to health savings accounts (HSAs) and Archer medical savings accounts (MSAs), and interest on education loans.

This proposal would apply to itemized deductions after they have been reduced by the statutory limitation on itemized deductions for higher income taxpayers.

Treasury's Green Book does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 36% tax bracket with a \$10,000 itemized deduction or exclusion would be able to reduce their tax liability by only \$2,800 on account of the deduction or exclusion, rather than \$3,600—a tax increase of \$8 per \$100 of itemized deductions compared with current law.

This provision would be effective for tax years beginning after December 31, 2015.

### **Reform the taxation of capital income**

Under current law, capital gains and qualified dividends are taxable only on the sale or other disposition of an appreciated asset. The long-term capital gains tax rate is generally 20% with an additional 3.8% net investment income tax, which may also be applicable on the gain. Currently, when an individual transfers assets at death, the recipient generally receives the assets with a basis equal to the fair market value of the asset on the date of death.

The administration's proposal would increase the tax rate on long-term capital gains and qualified dividends to 24.2%, which in conjunction with the 3.8% net investment income tax, would tax long-term capital gains at 28%. The administration's proposal would also treat the transfer of appreciated property (during life or at death) as a sale of the property. Transfers to a spouse or to a charity would not trigger the capital gains tax and would instead carry the basis of the donor or decedent. In addition, capital gains of \$100,000 per person or \$200,000 per couple (the exemption would be portable between spouses and indexed for inflation after 2016) could be transferred at death free of the capital gains tax, a \$250,000 per person or \$500,000 per couple exemption would be available for personal residences (such exemption would be automatically portable between spouses), and tangible personal property (items like furniture, clothing and small family heirlooms, but not expensive art and similar collectibles) would also be tax exempt. The proposal would also exclude certain small family-owned and family-operated business from the tax provisions with no tax being due on those businesses until they are actually sold. It also includes an option to pay tax on any gains not associated with liquid assets over 15 years using a fixed-rate payment plan.

The proposal would be effective for long-term capital gains realized and qualified dividends received in tax years beginning after December 31, 2015, and for gains on gifts made and for decedents dying after December 31, 2015.



## **KPMG observation**

This is a new provision, i.e., not included in a prior budget.

Gifts made during life do not currently receive stepped-up basis but instead have carry-over basis, and any related gain is realized when the recipient of the gift sells the asset. As such, the “loophole” the administration is trying to close does not exist in the gift tax context as such gains are ultimately taxed when the asset is sold. Prior discussions around eliminating stepped-up basis have generally been coupled with a proposal to eliminate the estate tax (i.e., either having an estate tax or a capital gains tax but not both). This proposal does not appear to affect the estate tax. Thus, if this provision and the provision to return the estate tax provisions to 2009 are fully implemented, an estate worth more than the exemption amount (\$3,500,000 per person under 2009 law) could face an estate tax of 45%, a tax on capital gains of 28%, and, where applicable, state estate and state income taxes. A New York resident with zero basis assets included in their estate could face a combined tax rate of around 75%.

## **Implement the Buffett rule by imposing a new “fair share tax”**

Under current law, individual taxpayers may reduce their taxable income by excluding certain income such as the value of health insurance premiums paid by employers and interest on tax-exempt bonds. They can also claim certain itemized or standard deductions in computing adjusted gross income such as state and local taxes and home mortgage interest. Qualified dividends and long-term capital gains are taxed at a maximum rate of 23.8% while ordinary income, including wages, is taxed at graduated rates as high as 39.6%.

The wage base for much of the payroll tax is capped at \$118,500 in 2015, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below that amount (although half this amount is the liability of the employer).

The administration’s FY 2016 proposal would impose a new minimum tax, called the “fair share tax” (FST), phasing in for taxpayers having \$1 million of AGI (\$500,000 if married filing separately). The tentative FST would equal 30% of AGI less a credit for charitable contributions. The charitable credit would equal 28% of itemized charitable contributions allowed after the limitation on itemized deductions (the “Pease limitation”). Final FST would be the excess of the tentative FST over regular income tax (including AMT and the 3.8% surtax on investment income, certain credits, and the employee portion of payroll taxes). The tax would be fully phased in at \$2 million of AGI (\$1 million if married filing separately). AGI thresholds would be indexed for inflation beginning after 2016.

The proposal would be effective for tax years beginning after December 31, 2015.

## **Impose a financial fee**

The administration proposes to impose a financial fee on financial entities. The administration cites excessive risk undertaken by major financial firms as a significant cause of the recent financial crisis and an ongoing potential risk to macroeconomic stability. The administration believes this fee will reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.<sup>1</sup>

The fee would apply to both U.S. and foreign banks; bank holding companies; and “nonbanks,” such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. Firms with worldwide consolidated assets of less than \$50 billion would not be subject to the fee for periods when their assets are below this threshold. According to the Green Book, U.S. subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of \$50 billion also would be covered.

The fee would apply to the “covered liabilities” of a financial entity. Covered liabilities would be “assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts (primarily for insurance companies).”

The rate of the fee applied to covered liabilities would be seven basis points, and the fee would be deductible in computing corporate income tax. A financial entity subject to the fee would report it on its annual federal income tax return. Estimated payments of the fee would be made on the same schedule as estimated income tax payments.

According to the administration’s estimates, the fee would raise \$112 billion over 10 years and would apply to roughly 100 firms with assets over \$50 billion.

The fee would be effective as of January 1, 2016.

### **KPMG observation**

While the administration previously proposed a similar fee on financial institutions, this fee proposal is much broader in scope and in purpose. The fee was previously proposed as a means to recoup remaining costs of assistance provided through the Troubled Asset Relief Program. Now, for the first time, the fee is described primarily as a disincentive to incur excess leverage.

The proposed fee could apply to many types of institutions not previously covered by similar proposals. The proposed fee would apply not just to banks, but could also apply

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<sup>1</sup> See Staff of the International Monetary Fund, “A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20” (June 2010).

to insurance companies, exchanges, asset managers, broker-dealers, specialty finance companies, and financial captives. This would greatly expand the base of entities subject to the tax. It is unclear how some of these entities (e.g., asset manager and specialty finance companies) would be defined.

The proposal would effectively apply to foreign-headquartered financial institutions, i.e., branches of foreign entities that have assets in excess of \$50 billion, and not just U.S. subsidiaries that meet the asset test. Some financial groups may end up with multiple groups subject to this fee, although the rule would presumably be drafted to avoid double-counting of assets and liabilities.

The definition of covered liabilities is also broader than prior proposals. Prior proposals excluded insured deposits from the calculation of covered liabilities. The current proposal would define covered liabilities as assets less equity based on audited financial statements, with no exclusion for deposits. The only exclusion would be for separate accounts, which primarily applies to insurance companies. It is unclear how this test would be applied to some of these types of entities (e.g., measuring assets and liabilities for entities with joint ventures).

## **LOOPHOLE CLOSERS**

### **Require current inclusion in income of accrued market discount and limit the accrual amount for distressed debt**

Market discount generally arises when a debt instrument is acquired in the secondary market for an amount less than its stated principal amount (or adjusted issue price, if it was issued with original issue discount (OID)). A holder of a debt instrument with market discount generally treats gain from a disposition of the instrument and principal payments under the instrument as ordinary income to the extent of the accrued market discount. Generally, market discount accrues ratably over the term of a debt instrument unless the holder elects to accrue on a constant yield basis instead. A holder may also elect to include market discount into income as it accrues.

The administration's FY 2016 proposal would require holders of debt instruments with market discount to include market discount currently in taxable ordinary income as it accrues. The proposal would require accrual of market discount on a constant yield basis. The proposal would also limit the accrual of market discount to the greater of: (1) the bond's yield to maturity plus 5%; or (2) the applicable federal rate for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2015.

## **KPMG observation**

The proposal is based upon the premise that market discount that arises as a result of changes in interest rates or decreases in an issuer's creditworthiness subsequent to issuance is economically similar to OID, and like OID is to be accrued into income currently.

The proposal notes that current inclusion of market discount has historically been complicated by the fact that the amount of market discount on a debt instrument can vary from holder to holder since it is based upon each holder's acquisition price. The new information reporting rules would require brokers to include, on annual information returns, market discount accruals together with basis and other information for debt instruments, simplifying taxpayer compliance as well as the administrability of the proposal. Brokers are required to report cost-basis information, including market-discount accruals, for less complex debt instruments acquired after 2013 and more complex debt instruments acquired after 2015.

## **Require that the cost basis of stock that is a covered security must be determined using an average cost basis method**

A taxpayer computes gain or loss upon disposition of stock as the difference between the stock's adjusted basis and its amount realized. Under current law, taxpayers who purchase identical stock at different times and for different prices may specifically identify which lots they sold. A first-in, first-out (FIFO) rule applies in the absence of a specific identification. An average basis method is permitted for stock in a regulated investment company, and for stock acquired in connection with a dividend investment plan.

For portfolio stock with respect to which the taxpayer has a long-term holding period, the administration's FY 2016 proposal would require taxpayers to determine the basis of stock sold using an average basis method. The average basis method would be applied to all identical shares of portfolio stock with a long-term holding period held by the taxpayer, including stock held through a different broker or in a separate account, but would not apply to shares held in a nontaxable account, such as an individual retirement account. The statute would provide authority to the Secretary to draft regulations applying the average basis method to stock other than portfolio stock. Special rules could also be required to coordinate the average basis method with the rules applicable to stock in passive foreign investment company.

The proposal would apply to portfolio stock acquired after December 31, 2015.

## **KPMG observation**

The proposal would only apply to portfolio stock with respect to which a taxpayer has a long-term holding period, and only to portfolio stock acquired on or after December 31, 2015. However, it does not define portfolio stock. This term is defined in section 246A, but it is not clear that the proposal is relying upon this definition.

The proposal would also require taxpayers to apply average basis to all identical stock, whether held in the same account or multiple accounts with different brokers. Because the broker cost-basis reporting rules for stock apply on an account-by account-basis, the proposal would require taxpayers holding identical stock in multiple accounts to compute their average basis across accounts rather than relying upon annual statements provided by their brokers.

## **Tax carried (profits) interests as ordinary income**

The administration's FY 2016 proposal includes a measure to tax carried interests in investment partnerships as ordinary income, effective for tax years ending after December 31, 2015. The proposal appears to be substantially the same as the proposal that was included in the administration's budget for the previous fiscal year. The proposal, reflects a different approach than that taken in the Camp tax reform bill.

The Green Book generally indicates that the administration's proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. The administration's proposal continues to provide exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

As was the case for the previous fiscal year's budget proposal, the Green Book continues to indicate that:

...to ensure more consistent treatment with the sales of other types of businesses, the [a]dministration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years**

Under the administration's FY 2016 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries. Eligible beneficiaries include any beneficiary who, as of the date of the account holder's death, is: (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant or IRA owner; or (4) a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner. However, in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

Any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The provision would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2015. The requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would apply to participants or IRA owners who die before January 1, 2015, but only if the beneficiary dies after December 31, 2015. The provision would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

### **Limit the total accrual of tax-favored retirement benefits**

Under the administration's FY 2016 proposal, a taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of \$210,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 years is approximately \$3.4 million based upon the current AFR of 0.00000002%.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at age 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, when actuarial equivalence is determined by treating the individual as if he or she was still age 62; the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation would automatically increase as well. This also could allow a resumption of contributions for a taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The provision would be effective with respect to contributions and accruals for tax years beginning on or after December 31, 2015.

### **Conform Self-Employment Contributions Act (SECA) taxes for professional service businesses**

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would change the employment tax rules with respect to professional

services businesses that are passthrough entities. “Professional services businesses” would include S corporations and entities classified as partnerships for federal tax purposes, substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, brokerage services, and lobbying. Thus, an expansive list of businesses would be covered.

Under the proposal, individual owners of professional services businesses that are passthrough entities would all be subject to Self-Employment Contributions Act (SECA) taxes in the same manner and to the same degree. More specifically, an individual owner and service provider who materially participates would be subject to SECA tax on his entire distributive share of passthrough income (subject to current law exceptions for items such as rents, dividends, and capital gains), while an owner who does not materially participate would be subject to SECA taxes only on an amount of income equal to “reasonable compensation,” if any, for services provided to the business. Material participation generally would be determined using the section 469 rules, except that the exception for limited partners would not apply in the SECA context. Reasonable compensation would be as large as guaranteed payments received from the business for services. Distributions of compensation to shareholders of professional services businesses that are S corporations would no longer be treated as wages subject to Federal Insurance Contributions Act (FICA) taxes, but would be included in earnings subject to SECA taxes.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Limit Roth conversions to pre-tax dollars**

The administration’s FY 2016 proposal would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includable in income if they were not rolled over. After-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans.

The proposal would apply to distributions occurring after December 31, 2015.

### **KPMG observation**

This provision is new to the FY 2016 budget.

### **Eliminate deduction for dividends on stock of publicly-traded corporations held in employee stock ownership plans**

The administration’s FY 2016 proposal would repeal the deduction for dividends paid with respect to employer stock held by an ESOP that is sponsored by a publicly traded



corporation. Rules allowing for immediate payment of an applicable dividend would continue, as would rules permitting the use of an applicable dividend to repay a loan used by the ESOP to purchase the stock of the publicly traded corporation. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

The proposal would apply to dividends and distributions that are paid after the date of enactment.

### **Repeal exclusion of net unrealized appreciation in employer securities**

The administration's FY 2016 proposal would repeal the exclusion of net unrealized appreciation in employer stock in the year of a distribution for participants in tax-qualified retirement plans who have not yet attained age 50 as of December 31, 2015. Participants who have attained age 50 on or before December 31, 2015 would not be affected by the provision.

The provisions would apply to distributions made after December 31, 2015.

### **Disallow the deduction for charitable contributions that are a prerequisite for purchasing tickets to college sporting events**

Under current law, donors generally must reduce the value of their charitable contributions by the value of any benefits received in exchange. However, current law permits donors to deduct 80% of the value of a contribution made to colleges and universities for the right to purchase tickets for seating at an athletic event.

Stating that the 20% disallowance may not accurately represent the value of the right received, the administration's FY 2016 proposal would deny the entire deduction for contributions that entitle donors to a right to purchase tickets to sporting events.

The proposal would be effective for contributions made in tax years beginning after December 31, 2015.

## **INCENTIVES FOR JOB CREATION, CLEAN ENERGY, AND MANUFACTURING**

### **Designate promise zones**

The administration's FY 2016 proposal would designate 20 promise zones (14 in urban areas and six in rural areas), including zones that competed for and received a promise zone designation in 2014 and 2015. Zone designations for the purpose of the tax incentives would be in effect from January 1, 2016 through December 31, 2025. The zones would be chosen through a competitive application process, inclusive of zones that were awarded promise zone designation in 2014 and 2015.

Two tax incentives would be applicable to promise zones. First, an employment credit would be provided to businesses that employ zone residents. The credit would apply to the first \$15,000 of annual qualifying zone employee wages. The credit rate would be 20% for zone residents who are employed within the zone and 10% for zone residents employed outside of the zone. The definition of a qualified zone employee would follow rules for a qualified empowerment zone employee.

Second, qualified property placed in service within the zone would be eligible for additional first-year depreciation of 100% of the adjusted basis of the property. Qualified property for this purpose includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property.

The proposal would be effective upon date of enactment.

### **Provide a tax credit for the production of advanced technology vehicles**

The administration's FY 2016 proposal would expand the types of alternative vehicles that are eligible for a tax credit.

Section 30D provides a credit for placing in service qualified plug-in electric drive motor vehicles. The maximum credit available for qualified vehicles is \$7,500 with a 200,000 vehicle per manufacturer limitation.

The administration's FY 2016 proposal would replace the credit for plug-in electric drive motor vehicles with a credit for "advanced technology vehicles." An advanced technology vehicle is a vehicle meeting the following criteria:

- The vehicle operates primarily on an alternative to petroleum;
- As of January 1, 2014, there were few vehicles in operation in the United States using the same technology as such vehicle; and
- The technology used by the vehicle exceeds the footprint-based target miles-per-gallon gasoline equivalent (MPGe) by at least 25%.

The credit would be limited to vehicles weighing no more than 14,000 pounds. Generally the credit would be the sum of \$5,000 and the product of 100 and the amount by which the vehicle's miles per gallon equivalent exceeds its footprint-based target miles per gallon, but would be capped at \$10,000 (\$7,500 for vehicles with an MSRP above \$45,000). The credit for a battery-powered vehicle would be determined under the current rules under section 30D if that computation results in a larger credit.

Under the administration's FY 2016 proposal, the credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle to the end-use purchaser of the vehicle. If the

credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of the depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after 2015 and before January 1, 2023, though the credit would step down by 25% each year starting in 2020.

### **Provide a tax credit for medium- and heavy-duty alternative-fuel commercial vehicles**

The administration's FY 2016 proposal would provide a tax credit for certain medium and heavy-duty weight vehicles that are powered by alternative fuels.

Section 30B provides credits for a taxpayer who places in service alternative motor vehicles. Currently, section 30B provides a credit for fuel-cell vehicles, and the credit is available for vehicles purchased before 2015. Section 30B also provides a credit for alternative-fuel motor vehicles; however, that credit expired in 2011.

The administration's FY 2106 proposal would allow a tax credit for dedicated alternative fuel vehicles weighing more than 14,000 pounds (i.e., trucks and buses). The administration would allow a credit of \$25,000 for vehicles weighing up to 26,000 pounds and a credit of \$40,000 for vehicles weighing more than 26,000 pounds.

The credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle or the vehicle's end-use purchaser. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of the depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after 2015, and before 2022. For vehicles placed in service in calendar year 2021, the credit would be limited to 50% of the otherwise allowable amount.

### **Modify and extend the tax credit for the construction of energy-efficient new homes**

The administration's FY 2016 proposal would modify and extend the section 45L credit for the construction of new energy efficient homes.

Under section 45L, the credit is \$1,000 per home for homes 30% more efficient in terms of heating and cooling than a comparable dwelling constructed in accordance with certain prescribed standards. The section 45L credit is \$2,000 per home for homes 50% more efficient than the standard. The credit applies to homes acquired before January 1, 2015.

For homes acquired after December 31, 2015, and before January 1, 2026, the proposal would provide a \$1,000 energy efficient new home tax credit for the construction of a qualified ENERGY STAR certified new home acquired for use as a residence. In addition, a \$4,000 tax credit would be provided for the construction of a qualified DOE Zero Energy Ready Home acquired for use as a residence. To provide that a new home meets ENERGY STAR or DOE Zero Energy Ready guidelines, verification by a qualified third party would be required.

### **Reduce excise taxes on liquefied natural gas (LNG) to bring into parity with diesel**

Beginning after 2015, the administration's FY 2016 proposal would lower the \$0.243 per gallon alternative fuel excise tax on LNG to \$0.141 per gallon so that the tax on LNG is at parity with diesel fuel on an energy-content adjusted basis.

Currently, an alternative fuel excise tax of \$0.243 cents per gallon is imposed on LNG delivered into the fuel supply tank of certain motor vehicles.

The tax would be dedicated to the Highway Trust Fund.

### **Enhance and modify the conservation easement deduction**

Under current law, a donor may deduct the fair market value of certain conservation contributions made to a qualified charitable organization. Although the current tax deduction provides important incentives for conservation, it has been of limited value to some donors while being susceptible to abuse and difficult to administer in other cases. The administration's FY 2016 proposal would make permanent the temporary enhanced deduction for conservation easement contributions that expired on December 31, 2014, and modify the conservation easement deduction, as follows:

- The proposal would require new regulations, based on the experiences and best practices developed in several States and by voluntary accreditation programs, to establish minimum requirements for organizations to qualify to receive deductible contributions of conservation easements by requiring such organizations to meet minimum requirements. The proposal states that an organization would jeopardize its status as a "qualified organization" by accepting contributions that it knows (or should know) are substantially overvalued or do not further an appropriate conservation purpose. The proposal also suggests that the regulations could specify, among other things, that a "qualified organization" (1) must not be related to the donor or to any person that is or has been related to the donor for at least ten years; (2) must have sufficient assets and expertise to be reasonably able to enforce the terms of all easements it holds; and (3) must have an approved policy for selecting, reviewing, and approving conservation easements that fulfill a conservation purpose.
- The proposal would modify the definition of eligible "conservation purposes" to require that all contributed easements further a clearly delineated federal

conservation policy (or an authorized state or tribal government policy) and yield significant public benefit.

- The proposal would require the donor to provide a detailed description of the conservation purpose or purposes furthered by the contribution, including a description of the significant public benefits it will yield. It would also require the donee organization to attest to the accuracy of the conservation purpose, public benefits, and fair market value of the easement reported to the IRS. The proposal would also impose penalties on organizations and organization managers that attest to values that they know (or should know) are substantially overstated or that receive contributions that do not serve an eligible conservation purpose.
- The proposal would amend section 6033 by requiring electronic reporting and public disclosure by donee organizations of the following: (1) deductible contributions of easements, including detailed descriptions of the subject property and the restrictions imposed on the property, the conservation purposes served by the easement, and any rights retained by the donor or related persons; (2) the fair market value of both the easement and the full fee interest in the property at the time of the contribution; and (3) a description of any easement modifications or actions taken to enforce the easement that were taken during the tax year.

The proposal would also authorize a pilot of an allocable credit for conservation contributions. The pilot would provide a non-refundable credit for conservation easement contributions as an alternative to the conservation contribution deduction. A federal agency would allocate \$100 million in credits per year to qualified charitable organizations and governmental entities, which would allocate the credits to donors. The proposal would permit donors to receive up to a maximum of 50% of the easement's fair market value and carry forward any unused credit amounts for up to 15 years. The Secretary of the Treasury, in collaboration with the Secretaries of Agriculture and the Interior, would be required to report to Congress on the relative merits of the conservation credit and the deduction for conservation contributions, including an assessment of the conservation benefits and costs of both tax benefits.

- The proposal would eliminate the deduction for contributions of conservation easements of a partial interest in property that is, or is intended to be, used as a golf course.
- The proposal would restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation, by disallowing a deduction for any value of a historic preservation easement associated with the restricted upward development above a historic building. To maintain consistency, the proposal would also extend the special rules applicable to buildings in registered historic districts to apply to buildings listed in the National Register.

The proposals would be effective for contributions made after the date of enactment.

## **MODIFY ESTATE AND GIFT TAX PROVISIONS**

### **Restore the estate, gift, and generation-skipping transfer (GST) tax parameters in effect in 2009**

The administration's FY 2016 proposal to make permanent the estate, GST, and gift tax parameters as they applied during 2009 is substantially similar to the provision included in the administration's FY 2015 budget, but with an effective date, which has been moved forward from decedents dying after December 31, 2018 to those dying after December 31, 2016.

### **Require consistency in value for transfer and income tax purposes**

The administration's FY 2016 proposal requiring that the basis of property received by reason of death under section 1014 must equal the value of that property for estate tax purposes and that the basis of property received by gift during the life of the donor under section 1015 must equal the donor's basis—along with other reporting and consistency requirements—is substantially similar to the provision included in the administration's FY 2015 budget.

The proposal would be effective for transfers after the year of enactment.

### **Modify transfer tax rules for grantor retained annuity trusts (GRATs) and other grantor trusts**

The administration's FY 2016 proposal to require that a GRAT have a minimum term of 10 years, a maximum term of the life expectancy of the annuitant plus 10 years, and prohibit any decrease in the annuity during the GRAT term is generally similar to the provision included in the administration's FY 2015 budget. However, the proposal has been changed to require that the remainder interest have a value equal to the greater of 25% of the value of the assets contributed to the GRAT or \$500,000 (but not more than the value of the assets contributed to the trust) at the time the interest is created. It has also been modified to prohibit the grantor from engaging in tax-free exchanges of trust assets.

This proposal would be applied to GRATs created after the date of enactment.

The administration's FY 2016 proposal, subjecting to estate tax as part of the grantor's gross estate, the portion of the trust attributable to property received by the trust in a sales transaction or exchange with the grantor, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction, is substantially similar to the provision included in the administration's FY 2015 budget.

The proposal would apply to grantor trusts that engage in a described transaction on or after the date of enactment.

### **KPMG observation**

The 2015 budget included a requirement that GRATs have a 10 year term and that they have a remainder interest valued at greater than zero, but imposed no minimum gift amount. The 2016 budget requirement of an immediate gift of at least \$500,000 would significantly increase the cost of using a GRAT to achieve estate planning benefits.

### **Limit duration of generation-skipping transfer (GST) tax exemption**

The administration's FY 2016 proposal providing that on the 90th anniversary of the creation of a trust the GST exemption allocated to the trust would terminate is substantially similar to the provision included in the administration's FY 2015 budget.

The proposal would apply to trusts created after enactment or to certain additions made to such a trust after enactment.

### **Extend the lien on estate tax deferrals where estate consists largely of interest in closely held business**

The administration's FY 2016 proposal to extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period, for the most part, is identical to the provision included in the administration's FY 2015 budget.

The proposal is generally applicable on the date of enactment.

### **Modify generation-skipping transfer (GST) tax treatment of Health and Education Exclusion Trusts (HEETs)**

The administration's FY 2016 proposal—clarifying that section 2611(b)(1) only applies to payments by a donor directly to the provider of the medical care or the school in payment of tuition and not to trust distributions, even if made for those same purposes—is substantially similar to the provision included in the administration's FY 2015 budget.

### **Simplify gift tax exclusion for annual gifts**

The administration's FY 2016 proposal—to eliminate the gift tax annual exclusion's present interest requirement with respect to certain gifts, and impose an annual gift tax annual exclusion limit per donor of \$50,000 (indexed for inflation after 2016) on transfers of property within a new category of transfers including transfers in trust (other

than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee—is substantially similar to the provision included in the administration’s FY 2015 budget.

The proposal would be effective for gifts made after the year of enactment.

### **Expand applicability of definition of executor**

The administration’s FY 2016 proposal to empower an authorized party to act on behalf of the decedent in all matters relating to the decedent’s tax liability by expressly making the Code’s definition of executor applicable for all tax purposes and authorizing such executor to do anything on behalf of the decedent in connection with the decedent’s pre-death tax liabilities or obligations that the decedent could have done if still living is substantially similar to the provision included in the administration’s FY 2015 budget.

The proposal would apply upon enactment.

## **OTHER REVENUE RAISERS**

### **Increase and Modify Oil Spill Liability Trust Fund Financing**

For periods beginning after 2015, the administration’s FY 2016 proposal would increase by \$0.01 per barrel the taxes imposed on crude oil and imported petroleum products under the Oil Spill Liability Trust Fund financing rate, to \$0.09 per barrel beginning on January 1, 2016, and to \$0.10 per barrel after December 31, 2016.

Currently, an excise tax is imposed on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil.

The administration’s proposal would extend the tax to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock. For periods after December 31, 2015, the proposal would also prohibit a drawback of the tax under the Customs drawback statute (19 U.S.C. 1313) when products subject to the tax are exported.

The tax would be dedicated to the Oil Spill Liability Trust Fund.



## **Reinstate Superfund taxes**

For periods beginning after December 31, 2015, and before January 1, 2026, the administration's FY 2016 proposal would reinstate the following Superfund excise taxes that were imposed before 1996:

- An excise tax on domestic crude oil and on imported petroleum products at a rate of \$0.097 per barrel. The tax would also be extended to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock.
- An excise tax on listed hazardous chemicals at a rate that varied from \$0.22 to \$4.87 per ton (chemical excise tax).
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

The administration's FY 2016 budget would also reinstate the corporate environmental income tax at a rate of 0.12% on the amount by which the modified alternative minimum taxable income (determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax) exceeded \$2 million.

The taxes would be dedicated to the Hazardous Substance Superfund Trust Fund.

## **Increase tobacco taxes and index for inflation**

For articles removed after December 31, 2015, the administration's FY 2016 proposal would increase the taxes imposed on cigarettes to approximately \$1.95 per pack and increase all other excise taxes on tobacco products by roughly the same proportion. These rates would be indexed for inflation annually beginning in 2017.

Currently, an excise tax is imposed on the following tobacco products and cigarette papers and tubes that are manufactured in or imported into the United States:

- Certain cigars and cigarettes at a rate that varies from \$50.33 (\$1.01 per pack of 20) to \$402.60 per thousand
- Certain smokeless tobacco, pipe tobacco, and roll-your-own tobacco at a rate that varies from \$.5033 to \$24.78 per pound (and a proportionate tax at the like rate on all fractional parts of a pound)

The proposal also includes a one-time floor stocks tax that generally applies to tobacco products (other than large cigars), cigarette papers, and tubes that are held for sale on January 1, 2015, and clarifies the definition of roll-your-own tobacco.

## **Make unemployment insurance surtax permanent**

The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6% of the first \$7,000 paid annually to each employee. The tax funds a portion of the federal / state unemployment benefits system. States also impose an unemployment tax on employers. Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4%, making the minimum net federal tax rate 0.6%.

Before July 1, 2011, the federal payroll tax had included a temporary surtax of 0.2%, which was added to the permanent FUTA tax rate. The surtax had been extended several times since its enactment in 1976, but it expired on July 1, 2011.

The administration's FY 2016 proposal would reinstate the 0.2% surtax and make it permanent.

The provision would be effective for wages paid on or after January 1, 2016.

## **Expand Federal Unemployment Tax Act (FUTA) Base**

The administration's FY 2016 proposal would raise the FUTA wage base in 2017 to \$40,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net federal UI tax from 0.8% (after the proposed permanent reenactment and extension of the FUTA surtax) to 0.165%. States with wage bases below \$40,000 would need to conform to the new FUTA base. States would maintain the ability to set their own tax rates, as under current law. The provision would impose a minimum tax rate requirement on states for their state employer tax rates equivalent to roughly \$70 per employee beginning in 2017.

The provision would be effective upon the date of enactment.

### **KPMG observation**

This provision modifies the previous budget proposal by increasing the FUTA wage base to \$40,000 from the previously proposed \$15,000. The current FUTA wage base is \$7,000.

## **REDUCE THE TAX GAP AND MAKE REFORMS**

### **KPMG observation**

Among other things, the administration proposes assorted amendments or additions to the various I.R.C. information reporting requirements (affecting Forms 1099, W-2, etc.). Purposes of the proposals include revenue enhancement, targeting tax avoidance, and fighting identity theft and other fraudulent activities. It is unknown what the overall effect

of these proposals will be on any particular taxpayer or entity, but these proposals, if passed, would increase—possibly significantly—the costs and burdens associated with the information reporting requirements applicable to a number of domestic and multinational industries and taxpayers.

## **Improve information reporting for certain businesses and contractors**

### *Require Form W-9 from contractors*

In general, a reportable payment made in the course of a trade or business to a service provider is not subject to withholding if the service provider furnishes a taxpayer identification number (TIN) to the payor prior to the time payment is made. The administration's FY 2016 proposal would require service providers to furnish their TINs on Form W-9, thereby certifying as to the correctness of their TINs. Service recipients would be required to verify the accuracy of the TIN with the IRS (through the IRS TIN matching program). Service providers that fail to furnish a certified TIN that matches IRS records would be subject to backup withholding. Alternatively, service providers could request (and require) the service recipient to withhold a flat-rate percentage (selected by the service provider) of the gross payment made.

The provision would be effective for payments made to contractors after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

### *Require information reporting for private separate accounts of life insurance companies*

The administration's FY 2016 proposal would require life insurance companies to report to the IRS—for each contract with cash value that is partially or wholly invested in a private separate account for any portion of the tax year and represents at least 10% of the value of the account—(1) the policyholder's taxpayer identification number; (2) the policy number; (3) the amount of accumulated untaxed income; (4) the total contract account value; and (5) the portion of that value that was invested in one or more private separate accounts.

For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies with cash values, in the aggregate, of at least 10% of the value of the separate account. Whether a related group of persons owns policies with cash values at 10% or greater of the account value would be determined quarterly, based on information reasonably within the contract issuer's possession.

The provision would be effective for private separate accounts maintained on or after December 31, 2015.

This provision was included in the administration's FY 2012 through FY 2015 revenue proposals.

**Provide an exception to the limitation on disclosing tax return information to expand TIN matching beyond forms where payments are subject to backup withholding**

Section 6103 provides that tax returns and tax return information are confidential and cannot be disclosed, unless a statutory exception applies. Section 6103(k) includes exceptions for disclosure of certain tax returns and tax return information for tax administration purposes. Under the broad regulatory authority in section 3406(i) to prescribe regulations necessary or appropriate to carry out the purposes of section 3406, the IRS implemented a voluntary TIN matching program for payors of payments subject to backup withholding. The TIN matching program has proven beneficial to taxpayers and the IRS because mismatches of TINs can be resolved before filing of returns.

Because the authority to disclose taxpayer information under the TIN matching program is limited to reportable payments subject to backup withholding under section 3406, taxpayers required to report information other than reportable payments subject to backup withholding are not eligible to participate in the TIN matching program. However, filers and the IRS would benefit if TIN matching were made more widely available.

The FY 2016 proposal would amend section 6103(k) to permit the IRS to disclose to any person required to provide the TIN of another person to the Secretary whether the information matches the records maintained by the Secretary.

The proposal would be effective on the date of enactment.

**Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act**

Under FATCA, foreign financial institutions are required to report account balances, as well as amounts such as dividends, interest, and gross proceeds paid or credited to a U.S. account without regard to the source of such payments. To implement FATCA, the United States has established a broad network of information exchange relationships with other jurisdictions based on established international standards. The success of those information exchange relationships depends on cooperation and reciprocity. Requiring U.S. financial institutions to report to the IRS the comprehensive information required under FATCA with respect to accounts held by certain foreign persons, or by certain passive entities with substantial foreign owners, would facilitate the intergovernmental cooperation contemplated by the intergovernmental agreements by enabling the IRS to provide equivalent levels of information to cooperative foreign

governments in appropriate circumstances to support their efforts to address tax evasion by their residents.

The administration's FY 2016 proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal. Finally, the proposal would require financial institutions that are required by FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

The proposal would be effective for returns required to be filed after December 31, 2016.

#### **KPMG observation**

This proposal could result in a significant increase in costs and burdens on U.S. businesses with respect to the proposed expansion of reporting. The addition requiring the furnishing of information to account holders is new to this proposal in 2016 and could further exacerbate these costs and burdens.

This provision was included in the administration's FY 2015 revenue proposal.

#### **Improve mortgage interest deduction reporting**

A deduction is allowed for qualified residence interest paid or accrued with respect to a primary residence and one secondary residence. A deduction is also allowed for property taxes paid. Any person, such as a lender or loan servicer, who in the course of their trade or business, receives from any individual interest aggregating \$600 or more for any calendar year on any mortgage is required to report to the IRS on a Form 1098, *Mortgage Interest Statement*, with respect to each individual from whom interest is received. The IRS uses the information it receives on the Form 1098 to verify the deduction of qualified residence interest claimed by the individual on their tax return.

Under the FY 2016 proposal, in addition to the information already reported on the Form 1098, filers would also be required to include information regarding the outstanding principal balance of the mortgage as of the beginning of the calendar year; the address

of the property securing the mortgage; information on whether the mortgage is a refinancing of an existing mortgage during the calendar year; property taxes, if any, paid from escrow; and the loan origination date.

The proposal would be effective for information returns due for calendar years beginning after December 31, 2015.

### **Require Form W-2 reporting for employer contributions to defined contribution plans**

Employers file Form W-2 to provide to each employee an annual statement showing the remuneration paid by the employer to the employee during the calendar year. A copy of the Form W-2 must also be filed with the Social Security Administration, which shares information on the form with the IRS. Employers are required to report an employee's elective deferrals under a cash or deferred arrangement, such as contributions to a 401(k) plan, on the employee's Form W-2. Employers are not currently required to report the employer's contributions to an employee's defined contribution retirement plan on the employee's Form W-2.

The administration's FY 2016 proposal would require employers to report the amounts an employer contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2.

The proposal would be effective for information returns due for calendar years beginning after December 31, 2015.

### **Improve compliance by businesses increase certainty with respect to worker classification**

Under a special non-Code provision (*Section 530 of the Revenue Act of 1978*), the IRS is prohibited from reclassifying an independent contractor to employee status, even when the worker may be an employee under the common law rules, if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. In addition to providing so-called "Section 530 relief" to service recipients, the 1978 legislation prohibited the IRS from issuing guidance addressing the proper classification of workers.

The administration's FY 2016 proposal would allow the IRS to require service recipients to prospectively reclassify workers who are currently misclassified. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases, the proper classification of workers may have been unclear. In addition, the proposal would lift the prohibition on worker classification guidance, with Treasury and the IRS being directed to issue guidance that: (1) interprets the common law in a neutral manner; and (2) provides narrow safe harbors and/or rebuttable presumptions. Service recipients would be

required to give notice to independent contractors explaining how they will be classified and the implications of such classification. Independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold federal income tax from their gross payments at a flat rate percentage selected by the contractor.

The provision would be effective upon enactment, but prospective reclassification of those workers covered by Section 530 would not be effective until the first calendar year beginning at least one year after the date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

### **KPMG observation**

This proposal could result in a significant increase in costs and burdens on U.S. businesses that have service providers currently classified as independent contractors. The reclassification to employees may have wide-spread implications outside of federal employment taxes and affect such matters as workers compensation, unemployment benefits, pension requirements, and state employment taxes.

This provision was included in the administration's FY 2015 revenue proposal.

### **Increase information sharing to administer excise taxes**

Prior to 2003, customs officials were employees of the Treasury Department, and the IRS and the Alcohol Tobacco Tax and Trade Bureau (TTB) were able to share tax information with customs officials. The transfer of customs officials in 2003 to the Department of Homeland Security without a change in the Code has resulted in limitations on the information that the IRS and the TTB may share with customs officials. The proposal would add employees of DHS (customs officials) involved in tax administration to the list of federal officers and employees to whom the IRS and TTB may disclose tax information.

The proposal would be effective on date of enactment.

### **Provide authority to readily share information about beneficial ownership information of U.S. companies with law enforcement**

Knowledge of the beneficial owners of an entity can help law enforcement officials identify and investigate criminals engaged in financial crimes related to money laundering and terrorism financing. In the United States, entities are organized under state rather than Federal law, and the states do not collect information regarding the beneficial ownership of the entities they form. Under Title 31, a beneficial owner of a private banking account is defined to mean an individual who has a level of control over, or entitlement to, the funds or assets in the account that, as a practical matter,

enables the individual(s), directly or indirectly, to control, manage, or direct the account.

However, this information cannot be shared with law enforcement officials in non-tax matters without a court order. In addition, because not all entities formed in the United States and U.S. territories are required to obtain an employer identification number (EIN) and provide responsible party information, criminals can hide their identity as beneficial owners of a criminal enterprise formed as an entity in the United States.

The FY 2016 proposal would provide various changes to the law in this area. The proposal would require that all entities formed in a U.S. state or a U.S. territory (U.S. entity) obtain an EIN, providing a universal identifier for these entities and ensure that responsible party information is provided for every U.S. entity. The proposal also would allow the Secretary or his delegate to share responsible party information with law enforcement without a court order to combat money laundering, terrorist financing, and other financial crimes.

The proposal would impose various penalties: a \$10,000 penalty for failure to obtain an identifying number unless the entity had reasonable cause for the failure, and a \$100 penalty for failure to update information provided to the Secretary when applying for an identifying number, which could also be waived for reasonable cause. The latter penalty would increase to \$1,000 for intentional failures (such as a pattern of failing to update information). The penalty for failure to update information would not be imposed for the same calendar year in which the penalty for failure to obtain an identifying number is imposed. If the entity failed to pay either of these penalties within 60 days of notice and demand for payment of the penalty, any person who is or was a responsible party for the entity would be jointly and severally liable for the penalty with the entity. The Secretary would have broad authority to prescribe regulations necessary to carry out these provisions. In addition, a willful failure to obtain an EIN for the purposes of hiding the existence of the entity or the identity of its responsible party, or evading or defeating tax, would be a felony.

Finally, the proposal also would provide the Secretary with the authority to impose anti-money laundering and counter-terrorism financing obligations on persons in the business of forming companies, and establish standards that States would be encouraged to adopt to improve their regulation and oversight of the incorporation process.

The proposed requirement that all U.S. entities obtain an EIN would apply to all such entities formed on or after 180 days after the date of enactment. However, the Secretary would have up to three years to implement the requirement that all U.S. entities have an identifying number. The penalties proposed would be effective for failures occurring after the date of enactment. The proposal would be effective to permit disclosures to law enforcement after the date of enactment of this Act.



## **Impose liability on shareholders to collect unpaid income taxes of applicable corporations**

The administration's FY 2016 proposal would add a new provision to the Code designed to impose liability on shareholders who engage in "Intermediary Transaction Tax Shelters." Previously, the IRS and Treasury identified Intermediary Transaction Tax Shelters as listed transactions that require disclosure on a tax return to avoid certain penalties. Intermediary Transaction Tax Shelters typically involve: (1) a sale of a controlling interest (at least 50%) in the stock of a C corporation; (2) that is undertaken as part of a plan; (3) to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation's stock. The C corporation is ultimately left with insufficient assets from which to pay the tax owned from the asset sale. This would occur, for example, when sales proceeds from the asset sale are used to repay acquisition financing.

Despite the IRS identifying such transactions as listed transactions, taxpayers continue to engage in these transactions due to the federal government's inability to efficiently collect the unpaid taxes, interest, additions to tax, or penalties owed by a C corporation that has insufficient assets to pay such amounts. Specifically, the proposal notes that under current law, outside of the consolidated return context, when a C corporation fails to pay income taxes, the federal government is often unable to collect amounts owed by the C corporation from its former shareholders.

The administration's FY 2016 proposal would create a new provision that would impose liability on shareholders who enter into Intermediary Transaction Tax Shelters. Specifically, the proposal would apply to shareholders who, pursuant to a plan, directly or indirectly, dispose of a controlling interest (at least 50%) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the C corporation. Such secondary liability would be imposed only after the C corporation is assessed income taxes and penalties and fails to pay such amounts within a specified time period. This deficiency would be governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment. Treasury would be granted authority to prescribe regulations to carry out the proposal.

For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two-thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold.

The provision would not apply to the disposition of certain publicly traded corporations, REITS, or RICs or the acquisition by a publicly traded entity or an entity that is consolidated for financial reporting purposes with a publicly traded entity.

The provision would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013.

This provision was included in the administration's FY 2015 revenue proposal.

### **Increase levy authority for payments to Medicare providers with delinquent tax debt**

As enacted in the *Achieving a Better Life Experience Act of 2014*, Treasury is authorized to continually levy up to 30% of a payment to a Medicare provider in order to collect a delinquent tax debt. Certain Medicare providers fail to comply with their federal income tax and/or employment tax obligations.

The administration's FY 2016 proposal would allow Treasury to levy up to 100% of a payment to a Medicare provider to collect unpaid taxes. This would assist in recovering a greater amount of delinquent taxes and would promote providers' compliance with their federal tax obligations.

The proposal would be effective for payments made after the date of enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Implement a program integrity statutory cap adjustment for tax administration**

Previous administrations and Congresses have used a budget mechanism called "a program integrity cap adjustment" to increase congressional allocations for annual budget appropriations. Under the mechanism, funding above the spending ceiling that is specified in the annual congressional appropriations process is granted for specified "program integrity" purposes. This process has been critical in maintaining the IRS enforcement and compliance functions, allowing the IRS to initiate new programs that generate high returns on investment, and encouraging taxpayers to comply with the tax laws.

The administration's FY 2016 proposal would make an adjustment to the discretionary spending limits for IRS tax enforcement, compliance, and related activities. These resources would help the IRS continue to target international tax compliance and restore previously reduced enforcement levels. The total cost of supporting new initiatives above the funding needed to maintain current levels of enforcement and compliance activity through 2025 would be approximately \$18.7 billion over the budget window.

This provision was included in the administration's FY 2015 revenue proposal.

## **Streamline audit and adjustment procedures for large partnerships**

The IRS encounters many auditing and adjustment problems for partnerships that have a large number of partners. The *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA) established certain rules applicable to all but certain small partnerships. The purpose of the TEFRA partnership rules is to provide consistent treatment of partnership items among all partners on both partnership returns and partnership audits, and to lessen the administrative and judicial burdens placed on the government. The Tax Relief Act of 1997 established a second streamlined audit and adjustment procedure for a large partnership, as well as a simplified reporting system for partnerships that have 100 or more partners during the preceding tax year and that elect to be treated as an electing large partnership (ELP).

According to the Green Book, the present TEFRA partnership procedures remain inefficient and more complex than those applicable to other large entities. Further, few large partnerships have elected into the ELP regime, which was intended to mitigate the problems associated with large partnerships.

The administration's FY 2016 proposal would repeal the existing TEFRA and ELP procedures and create new simplified partnership procedures (SPP) for any partnership that has 100 or more direct partners in the aggregate during the tax year of the adjustment or has any one partner that is a pass-through partner, i.e., another partnership, estate, trust S corporation, nominee or similar person. A partnership subject to the SPP regime, because it has a passthrough partner, may elect out of the SPP regime if it can demonstrate that it has fewer than 100 direct and indirect partners in the aggregate in the year of the proposed adjustment.

The IRS would audit the partnership (source partnership) and make adjustments at the partnership level that flow to the partners who held interests in the year of the adjustments. Any additional tax due would be assessed in accordance with the direct partner's ownership interest for that year, and any direct partner that is a passthrough partner would be required to pay the tax for its members. Passthrough partners would have 180 days to challenge the assessment based on the tax attributes of its direct and indirect partners for the year to which the adjustments are made.

Unlike the TEFRA rules, the SPP would allow only the partnership to request a refund and partners would have no right to participate in the partnership level proceedings. The IRS would not be required to give notice to partners of the partnership audit or the final partnership adjustment. The IRS would be required to give notice only to the source partnership, and only the source partnership through an authorized person, a U.S. individual identified on the partnership return, could participate in the examination. If the partnership fails to make a designation, the IRS would make the designation of the authorized person.

Similar to TEFRA, the SPP require partners to report partnership items consistent with the partnership, and failure to notify the IRS of inconsistent treatment allows the IRS to assess any tax under its math error authority. However, if the partner does notify the IRS of inconsistent treatment, the IRS is required to audit the partnership to assess tax against the partner, which is different from TEFRA where the IRS could issue a notice of deficiency against the partner without a partnership audit.

Treasury would be given authority to promulgate necessary and appropriate regulations to implement the proposal to: include rules about the designation of a person to act on behalf of the partnership; ensure that taxpayers do not transfer partnership interests with a principal purpose of utilizing the SPP regime to alter taxpayer's tax liability; address foreign passthrough partners issues; and provide rules for passthrough partners to challenge an assessment.

### **KPMG observation**

This proposal has many unanswered questions concerning its implementation and consequences especially with respect to passthrough partners. For example, if a passthrough partner is a 10% partner, does the IRS simply assess tax on 10% of the adjustment at the highest rate of tax without regard to whether any of the indirect partners are: (1) tax-exempt entities; (2) would not have any additional tax liability if the adjustments were passed through, etc. This would result in a tremendous burden and cost on each partnership in a multi-tiered partnership arrangement to challenge the adjustment and have its partners file amended returns or prove that the tax has been paid. The change in the SPP that does not allow a partner to participate in the audit is also troubling as a partner's rights to challenge the merits of the adjustment have been abrogated and the failure of the authorized person to present a robust defense may cause the partner to have a deficiency on a partnership item that the partner cannot challenge. The partner may challenge the calculation of the deficiency but not the merits of the adjustment. This proposal incorporates some of the principles discussed in the Camp tax reform bill.

The proposal would apply to a partnership's tax year ending on or after the date that is two years from the date of enactment.

The 2015 proposal also would have eliminated TEFRA but retained ELP and created a new regime that was much different from the SPP proposal.

### **Revise offer-in-compromise application rules**

The administration's FY 2016 proposal would repeal a 2006 provision that requires an offer-in-compromise applicant to make certain non-refundable payments as part of its application.

The provision would be effective for offers-in-compromise submitted after the date of enactment.

This provision was included in the administration's 2015 revenue proposal.

### **Expand IRS access to information in the National Directory of New Hires for tax administration (NDNH) purposes**

The Department of Health and Human Services maintains the NDNH, a database of new-employee data from Form W-4, quarterly wage data from state and federal employment security agencies, and unemployment benefit data from state unemployment insurance agencies. The administration's FY 2016 proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes, including data matching, claim verification and identification of levy sources. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

The provision would be effective upon enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Make repeated willful failure to file a tax return a felony**

Under the administration's FY 2016 proposal, any person who willfully fails to file tax returns for three years within any five consecutive year period—if the aggregated tax liability for such period is at least \$50,000—would be subject to a felony and an aggravated failure to file criminal penalty of not more than \$250,000 (\$500,000 in the case of a corporation) or imprisonment for not more than five years or both.

The penalty would be effective for returns required to be filed after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

### **Facilitate tax compliance with local jurisdictions**

Although tax returns and return information generally are confidential, the IRS and Treasury may share information with states and certain local governmental entities that are treated as states for this purpose. Indian tribal governments are treated as states for several purposes, including certain charitable contributions, excise tax credits, and local tax deductions, but not for information sharing purposes.

Under the administration's FY 2016 proposal, Indian tribal governments that impose alcohol, tobacco, or fuel excise taxes or income or wage taxes would be treated as states for purposes of information sharing to the extent necessary for tax administration.

A tribal government that receives tax information would be required to safeguard it according to prescribed protocols. Criminal and civil sanctions would apply.

The provision would be effective for disclosures made after the date of enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Extend statute of limitations for assessment for overstated basis and state adjustments**

The administration's FY 2016 proposal would create an exception to the three-year statute of limitations for assessment of federal tax liability when the assessment is the result of adjustments to state or local tax liabilities. The statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer files an amended tax return with the IRS reflecting adjustments to the state or local tax return; or (2) two years from the date the IRS receives information from the state or local revenue agency under an information sharing agreement. The statute would be extended only with respect to the increase in federal tax attributable to the state or local tax adjustment.

The statute of limitations on claims for refund would be extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the state or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

The proposal also would amend the rules for determining gross income for purposes of the section 6501(e) six-year assessment period applicable to substantial omissions from gross income to provide that an understatement of gain is treated as an omission from gross income. As a result, an overstatement of basis and other unrecovered amounts that reduce the amount of gain reported on a return will be treated as an omission of gross income for purposes of determining whether the taxpayer omitted gross income in excess of 25% of the gross income stated on the return.

#### **KPMG observation**

The overstated basis proposal is similar to a provision contained in the Camp tax reform bill. It also is a response to the 2012 U.S. Supreme Court case *United States v. Home Concrete & Supply, LLC*, which held that an overstated basis does not constitute an omission from gross income for purposes of the six-year assessment period.

The proposal would be effective for returns required to be filed after December 31, 2015.

The provision regarding state adjustments was included in the administration's 2015 revenue proposal. The provision regarding overstated basis is new in FY 2016.

## **Improve investigative disclosure statute**

Taxpayer privacy would be clarified under the administration's FY 2016 proposal by stating that it does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The provision would be effective for disclosures made after enactment.

This provision was included in the administration's 2015 revenue proposal.

## **Allow the IRS to absorb credit and debit card processing fees for certain tax payments**

Currently, the IRS allows a taxpayer to make credit or debit card payments in certain circumstances, but the providers charge the taxpayer a convenience fee over and above the taxes due.

The administration's FY 2016 proposal would amend section 6311(d) to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

The provision would be effective for payments made after the date of enactment.

This provision was included in the administration's FY 2015 revenue proposal.

## **Provide the IRS with greater flexibility to address correctable errors**

In general, if the IRS determines that there is a deficiency, the IRS issues a statutory notice of deficiency and the taxpayer is provided an opportunity to challenge the proposed deficiency in the U.S. Tax Court before the deficiency is assessed. Section 6213(b) provides an exception from the general deficiency procedures by granting the IRS authority to correct certain mathematical or clerical errors made on tax returns, i.e., math error authority. "Mathematical and clerical error" is defined in section 6213(g)(2) and includes, for example, errors in addition, subtraction, multiplication, or division shown on the return or an entry on a return of an item that is inconsistent with another entry of the same or another item on the return. Currently, this section must be amended each time Congress wishes to expand the scope of math error authority.

The administration's FY 2016 proposal would remove the existing specific grants of math error authority, and provide that "math error authority" will refer only to computational errors and the incorrect use of any table provided by the IRS. In addition, the proposal would add a new category of "correctable errors." Under this new category,

Treasury would have regulatory authority to permit the IRS to correct errors in cases when: (1) the information provided by the taxpayer does not match the information contained in government databases; (2) the taxpayer has exceeded the lifetime limit for claiming a deduction or credit; or (3) the taxpayer has failed to include with his or her return documentation that is required by statute.

The proposal would be effective on the date of enactment. However, the IRS's current grant of math error authority would continue to apply until Treasury and the IRS issue final regulations addressing correctable errors.

This provision was included in the administration's FY 2015 revenue proposal.

## **Enhance electronic filing of returns**

### *Require greater electronic filing of returns*

Currently, corporations that have assets of \$10 million or more and that file at least 250 returns (including information returns) per year and partnerships with more than 100 partners are required to file electronically. Under the administration's FY 2016 proposal, all corporations and partnerships with \$10 million or more in assets would be required to file electronically. In addition, regardless of asset size, corporations with more than 10 shareholders and partnerships with more than 10 partners would be required to file their tax returns electronically, and preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file these returns electronically.

Regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as Forms 1042-S, 1099, 1098, 1096, 5498, 8805, and 8966. Any new regulations would be required to balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement if they cannot meet the requirement due to technological constraints, if compliance with the requirement would result in undue financial burden, or as otherwise specified in regulations.

The proposal would be effective for tax years beginning after the date of enactment.

### *Make e-filing mandatory for exempt organizations*

The administration's FY 2016 proposal would require that all Forms 8872 and Form 990 series tax and information returns be filed electronically and would require the IRS to make the electronically filed Forms 8872 and Form 990 series returns publicly available in a machine readable format in a timely manner, as provided in regulations.



The proposal generally would be effective for tax years beginning after the date of enactment. Transition relief would allow up to three additional years to begin electronic filing for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time. In addition, the proposal would give the IRS discretion to delay the effective date for Form 990-T filers for up to three tax years.

*Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a scannable bar code*

Taxpayers can currently prepare their tax returns electronically (either by utilizing a tax return preparer or using tax return software at home) and, instead of filing their returns electronically, may print out a paper copy and file the returns on paper by mailing it to the IRS.

The administration's FY 2016 proposal would provide the Secretary with authority to require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns with a scannable bar code that can be scanned that would enable the IRS to convert the paper return into an electronic format.

The provision would be effective for tax years beginning after the date of enactment.

*Impose a penalty on failure to comply with electronic filing requirements*

A return that is required to be e-filed but is instead filed on paper can be treated as a failure to file, but no penalty may result if the corporation is in a refund, credit, or loss position (as the penalty is based on the underpayment of tax). The administration's FY 2016 proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The penalty would be \$25,000 for a corporation and \$5,000 for a tax-exempt organization unless reasonable cause for the failure to file electronically is established. For failure to file in any format the existing penalties would remain and the proposed penalty would not apply.

The penalty would be effective for returns required to be electronically filed after December 31, 2015.

These provisions were separately included in the administration's FY 2015 revenue proposal.

## **Improve the whistleblower program**

### *Provide whistleblowers with protection from retaliation*

Section 7623 allows whistleblowers to file claims for an award for information that allowed the IRS to detect tax underpayments or detect and bring to trial and punishment persons guilty of violating the internal revenue laws.

Other whistleblower statutes, such as the False Claims Act, explicitly provide whistleblowers with protection from retaliatory actions and allow whistleblowers to file claims in U.S. district courts for relief, including reinstatement, back pay, and other damages. There are currently no protections from retaliatory action for whistleblowers who file claims under section 7623. This lack of protection from retaliation may discourage whistleblowers from filing claims with the IRS.

The administration's FY 2016 proposal would amend section 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act.

The proposal would be effective upon enactment.

### *Provide stronger protection from improper disclosure of taxpayer information in whistleblower actions*

Section 6103 provides that tax returns and tax return information are confidential, unless an exception applies. Section 6103(p) imposes safeguarding requirements on certain disclosures of tax return information. In addition, civil and criminal penalties may be imposed on an unauthorized inspection or disclosure of tax return information.

Currently, the IRS Whistleblower Office may share tax return information with whistleblowers and their legal representatives in a whistleblower administrative proceeding under section 6103(h) or by entering into a written agreement with the IRS under section 6103(n). Whistleblowers and their representatives who receive tax return information under section 6103(n) are subject to the section 6103(p) safeguarding requirements, including civil and criminal penalties for unauthorized inspections and disclosures. The same section 6103(p) safeguards do not extend to information disclosed to whistleblowers under section 6103(h).

The administration's FY 2016 proposal would extend the section 6103(p) safeguarding requirements to whistleblowers and their legal representatives who receive tax return information in whistleblower administrative hearings. In addition, the proposal would extend the penalties to unauthorized inspections and disclosures of tax return information to whistleblowers and legal representatives.

The proposal would be effective upon enactment.

These provisions were separately included in the administration's 2015 revenue proposal.

### **Index all civil tax penalties for inflation**

The Code currently contains numerous penalty provisions in which a fixed penalty amount was established when the penalty was initially added to the Code. These provisions contain no mechanism to adjust the amount of the penalty for inflation, and thus, these penalties are only increased by amending the Code.

The *Achieving a Better Life Experience Act of 2014*, enacted on December 19, 2014, has already adjusted the following penalties for inflation after 2014: section 6651 penalty for failure to file a tax return or pay tax; section 6652(c) penalty for failure to file certain information returns; section 6695 return preparer penalty; section 6698 penalty for failure to file a partnership return; section 6699 penalty for failure to file an S corporation return; section 6621 penalty for failure to file correct information returns; and section 6722 penalty for failure to furnish correct payee statements.

The administration's FY 2016 proposal would index all penalties to inflation and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment.

This provision was included in the administration's 2015 revenue proposal.

### **Extend IRS authority to require truncated Social Security Numbers (SSN) on Form W-2**

Currently, employers are required to include an employee's SSN on the copy of Form W-2 furnished to employees. Other information returns provided to taxpayers, such as Forms 1099, are subject to more general rules that require the taxpayer's "identifying number" to be reported on the information return. When an identifying number is required, Treasury and the IRS have regulatory authority to permit filers to use a number other than the taxpayer's SSN. In an effort to combat identity theft, Treasury and the IRS have permitted filers of certain information returns to truncate a taxpayer's identifying number, including an SSN, on the information return copy provided to the taxpayer.

The administration's FY 2016 proposal would require employers to include an "identifying number" for each employee, rather than an employee's SSN, on Form W-2. This would allow Treasury and the IRS to exercise regulatory authority to require or permit a truncated SSN on Form W-2.

The proposal would be effective upon enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Combat tax-related identity theft**

#### *Add tax crimes to the aggravated identity theft statute*

The "aggravated identity theft statute" permits an increased sentence when the identity of another individual is used to commit certain crimes, which currently do not include any tax crimes. A conviction for aggravated identity theft adds two years to the sentence imposed for the underlying felony.

The administration's FY 2016 proposal would subject certain tax-related crimes to the "aggravated identity theft statute."

The proposal would be effective upon enactment.

#### *Impose a civil penalty on tax identity theft crimes*

Tax identity theft has increased exponentially in recent years. The IRS issued an identity protection personal identification number to 1.2 million individuals for the 2014 filing season an increase from about 777,000 such numbers in the previous year. Current law does not impose a civil penalty for tax-related identity theft.

The administration's FY 2016 proposal would add a \$5,000 civil penalty on individuals who file a fraudulent return in connection with a tax identity theft case. Under the proposal, the IRS would be able to immediately assess a separate civil penalty for each incidence of identity theft, with no limit on the penalty amount imposed.

The proposal would be effective upon enactment.

These provisions were separately included in the administration's FY 2015 revenue proposal.

### **Allow states to send notices of intent to offset federal tax refunds to collect state tax obligations by regular first-class mail instead of certified mail**

The administration's FY 2016 proposal would remove the statutory requirement to use certified mail, thereby allowing Treasury's Bureau of Fiscal Service to amend its regulations to permit the States to send notices for delinquent State income tax obligations to debtors by first class mail.

The proposal would be effective on the date of enactment.

This provision was included in the administration's FY 2015 revenue proposal.

## **Rationalize tax return filing due dates so they are staggered**

Third-party information is used by taxpayers to assist them in preparing their income tax returns. However, many taxpayers do not receive Schedules K-1 before their income tax returns are due.

The administration's FY 2016 proposal would rationalize income tax return due dates so that taxpayers receive Schedules K-1 before the due date for filing their income tax returns. Under the proposal, calendar year S corporation filing deadlines would remain the same, and partnership filing deadlines would be made to conform to the current deadlines imposed on S corporations. Accordingly, all calendar year partnership and all calendar year S corporation returns (Forms 1065 and 1120-S) and Schedules K-1 furnished to partners and shareholders would be due March 15. In addition, returns of calendar year corporations other than S corporations would be due April 15 instead of March 15. Fiscal year partnership returns would be due the 15<sup>th</sup> day of the third month following the close of the tax year and fiscal year corporations other than S corporations would be due by the 15<sup>th</sup> day of the fourth month following the close of the tax year.

The proposal would also accelerate the due date for filing information returns and eliminate the extended due date for electronically filed returns. Under the proposal, information returns would be required to be filed with the IRS (or SSA, in the case of Form W-2) by January 31, except that Form 1099-B would be required to be filed with the IRS by February 15. The due dates for the payee statements would remain the same.

The proposal would be effective for returns required to be filed after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

## **Increase oversight and due diligence of paid tax return preparers**

### *Extend paid preparer earned income tax credit (EITC) due diligence requirements to the child tax credit*

Currently, paid preparers who prepare federal income tax returns that involve an EITC must meet certain due diligence requirements or face a penalty of \$500 for each return for which the requirement was not met. For each tax return, a paid preparer must complete the *Paid Preparer's Earned Income Credit Checklist* (Form 8867) and the checklist must be filed with the taxpayer's return. The paid preparer is also responsible for fulfilling record-keeping requirements.

The administration's FY 2016 proposal would extend the due diligence requirement to include all federal income tax returns that claim the child tax credit, including the

additional child tax credit. The existing checklist would be expanded and adapted to reflect the differences in requirements between the EITC and the child tax credit, while ensuring that the additional burden to preparers and filers is minimized.

The proposal would be effective for returns required to be filed after December 31, 2015.

*Explicitly provide that Treasury and the IRS have authority to regulate all paid return preparers*

In 2009, Treasury and the IRS amended Circular 230 to regulate practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled. Paid tax return preparers challenged these regulations in *Loving v. Commissioner*. The U.S. Court of Appeals for the District of Columbia Circuit determined that these regulations exceeded the IRS's authority.

The proposal would explicitly provide that the Secretary has the authority to regulate all paid tax return preparers.

The proposal would be effective on or after the date of enactment.

*Increase the penalty applicable to paid tax preparers who engage in willful or reckless conduct*

Currently the same 50% of the income derived (or to be derived) penalty may apply to preparers regardless of whether the preparer's conduct was willful and reckless. The proposal increases the penalty rate in section 6694(b) on paid tax returns for understatements due to willful or reckless conduct to the greater of the \$5,000 or 75% of the income derived (or to be derived) by the prepared with respect to the return or claim for refund.

The proposal would be effective for returns required to be filed after December 31, 2015.

These provisions were separately included in the administration's FY 2015 revenue proposal.

**Enhance administrability of the appraiser penalty**

Currently, there is no coordination between the section 6695A penalty on appraisers and the section 6694 understatement penalty on return preparers in cases when the person providing the appraisal is also treated as a paid tax return preparer with respect to the position on the return or claim for refund relying on the valuation in the appraisal. Therefore, a paid tax return preparer could be subject to penalties under both section 6694 and section 6695A with respect to the same conduct.

The administration's FY 2016 proposal would replace the existing "more likely than not" exception to the section 6695A appraiser penalty with a reasonable cause exception. In addition, the proposal would coordinate the section 6694 and section 6695A penalties so that an appraiser would not be subject to the penalty under section 6695A if, by reason of that appraisal, the appraiser is also subject to a penalty under section 6694.

The proposal would be effective for returns required to be filed after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

## **SIMPLIFY THE TAX SYSTEM**

### **Modify adoption credit to allow tribal determination of special needs**

Under current law, taxpayers that adopt children can claim a tax credit for qualified adoption expenses. The amount of the credit is increased for the adoption of a special needs child. For this increased credit to be available, a state must determine that the child meets the statutory requirements of a "child with special needs." Other government entities, such as Indian tribal governments (ITGs) do not have the authority to make this determination.

The Indian Child Welfare Act was enacted by Congress to allow Indian tribes, instead of the state, to manage adoption programs for the children of their tribal members. These include adoptions involving special needs.

The administration's FY 2016 proposal would amend the tax credit for adoption expenses to allow ITGs to make the status determination of a "child with special needs", so as to accord ITGs the same deference as state agencies for purposes of the tax credit for adoption expenses.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Repeal non-qualified preferred stock (NQPS) designation**

The administration's FY 2016 proposal would remove from the Code the designation NQPS and the treatment of such stock as "boot."

Section 351(g) excepts from the general nonrecognition rule of section 351 transfers of property to a corporation in exchange for NQPS of that corporation. NQPS is stock that: (1) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (2) has a dividend rate that varies with reference to an index, or in certain circumstances, a put right, call right, or a mandatory redemption

feature. NQPS also may be treated as boot if it is received in certain shareholder exchanges pursuant to a plan of reorganization.

The proposal notes that NQPS commonly is used in corporate tax planning in a variety of ways. For example, the transfer of an asset with a built-in loss to a controlled corporation in exchange for NQPS of that corporation generally allows the transferor to recognize the loss (subject to loss limitation rules such as section 267) and to avoid the general nonrecognition rule of section 351. In addition, the use of NQPS to acquire stock of a related party may help avoid deemed dividend treatment that might otherwise result from a related-party stock purchase under section 304.

In enacting the NQPS provisions in 1997, Congress recognized that certain types of preferred stock more appropriately represented taxable consideration because the transferor obtained a more secure form of investment. The administration's FY 2016 proposal embodies a belief that transactions such as those described above may be either inconsistent with Congress's original intent in enacting the provision and/or may otherwise add unnecessary complexity.

The proposal would repeal the NQPS provision in section 351 (and any other cross-referencing provision of the Code) for stock issued after December 31, 2015.

#### **KPMG observation**

The administration's FY 2012 through FY 2015 proposals had similar provisions. The reference in the proposal to the use of NQPS in related-party stock sales to avoid deemed dividend treatment is interesting in light of the fact that all stock (whether NQPS or otherwise) is not "property" for purposes of section 304. Thus, it would seem that any stock (regardless of its classification as NQPS or otherwise) may be used to avoid section 304. However, if this change is enacted, NQPS no longer could be used to avoid both section 304 deemed dividend treatment and section 351 nonrecognition treatment with respect to the same transfer if section 351 would be applicable. Thus, the proposal, if enacted, still would limit tax planning opportunities (as well as protect taxpayers from inadvertently planning into a taxable exchange) related to the use of NQPS in related-party stock sales.

#### **Repeal preferential dividend rule for publicly traded and publicly offered real estate investment trusts (REITs)**

The administration's FY 2016 budget proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

- As of the record date of the distribution, the REIT was publicly traded
- As of the record date of the distribution—



- The REIT was required to file annual and periodic reports with the SEC under the Securities Act of 1934
- Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318)
- Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period

Treasury would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule when it continues to apply and, when appropriate, to require consistent treatment of shareholders.

The provision would apply to distributions that are made (without regard to section 858) in tax years beginning after the date of enactment.

### **Reform excise tax based on investment income of private foundations**

The administration's FY 2016 proposal would replace the two rates of tax on private foundations that are exempt from federal income tax with a single tax rate of 1.35%. The tax on private foundations not exempt from federal income tax would be equal to the excess (if any) of the sum of the 1.35% excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax-exempt, over the income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions would be repealed.

The proposal would be effective for tax years beginning after the date of enactment.

### **Remove bonding requirements for certain taxpayers subject to federal excise taxes on distilled spirits, wine, and beer**

Effective 90 days after the date of enactment, the administration's FY 2016 proposal would require a taxpayer subject to the excise tax on any distilled spirits, wines, and beer and who reasonably expects to be liable for not more than \$50,000 per year in alcohol excise taxes (and who was liable for not more than \$50,000 of such taxes in the preceding calendar year) to file and pay such taxes quarterly, rather than semi-monthly. The proposal would also create an exemption from the bond requirement in the Code for these taxpayers. Additionally, the proposal would allow a taxpayer with a reasonably expected liability for these alcohol excise taxes of not more than \$1,000 per year to file and pay such taxes annually rather than on a quarterly basis. The proposal would create parity among alcohol taxpayers by allowing eligible distilled spirits and beer taxpayers to file annually as well.

## **Streamline private business limits on governmental bonds**

Currently, section 141 treats tax-exempt bonds issued by state and local governments as governmental bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as “private activity bonds.” Bonds generally are classified as private activity bonds if more than 10% of the bond proceeds are both (1) used for private business use, and (2) payable or secured from property or payments derived from private business use. Section 141(b)(3) reduces the 10% threshold to 5% when testing for unrelated or disproportionate private business use.

To simplify the private business limits on tax-exempt governmental bonds, the proposal would repeal this 5% unrelated or disproportionate private business use test. The proposal would be effective for bonds issued after the date of enactment.

## **Repeal technical terminations of partnerships**

Under current law, a partnership can “technically terminate” under section 708(b)(1)(B) if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in both partnership capital and partnership profits. If a partnership technically terminates, certain events are deemed to take place to effectuate the tax fiction that the “old” partnership has terminated and a “new” partnership has begun.

As was generally the case for the FY 2015 proposal, the administration’s FY 2016 proposal would repeal the technical termination rule of section 708(b)(1)(B), effective for transfers after December 31, 2015.

### **KPMG observation**

Technical terminations can raise significant federal tax issues, many of which can be unfavorable from a taxpayer’s perspective, but some of which can be favorable in particular fact situations. In addition, technical terminations raise compliance considerations. As a result, under current law, it can be important for partnerships to monitor sales and exchanges of their interests to determine if technical terminations may be triggered and to assess the consequences of such terminations based on their particular facts. Repealing the technical termination rules would reduce compliance burdens and would eliminate consequences—favorable and unfavorable—that can result in particular cases.

## **Repeal anti-churning rules of section 197**

Under current law, as enacted in 1993, section 197 allows the amortization of certain intangible assets (such as goodwill and going-concern value). Prior to the enactment of section 197, many such intangibles were not amortizable. The anti-churning rules in section 197(f)(9) exclude an asset that was not amortizable before the enactment of section 197 from the definition of “amortizable section 197 intangible” if:

- The intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the “transition period”) by the taxpayer or a related person;
- The taxpayer acquired the intangible from a person who held it at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or
- The taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

The administration’s FY 2016 proposal would repeal the anti-churning rules in section 197(f)(9) effective for acquisitions after December 31, 2015.

### **Repeal special estimated tax payment (SEPT) provision for certain insurance companies**

The administration’s FY 2016 proposal would repeal section 847, effective for tax years beginning after December 31, 2015. The entire balance of any existing special loss discount account would be included in gross income for the first tax year beginning after December 31, 2015, and the entire amount of existing SETPs would be applied against additional tax that is due as a result of the provision. Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.

In lieu of immediate inclusion in gross income of the full special loss discount account balance for the first tax year beginning after December 31, 2015, taxpayers could elect to include the amount in gross income ratably over a four-tax-year period, beginning with the first tax year beginning after December 31, 2015. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of the income inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

### **KPMG observation**

This provision, which is revenue neutral and is designed to reduce recordkeeping burdens, is consistent with the Camp tax reform bill and was included in the administration’s FY 2011 through FY 2015 revenue proposals.

### **Repeal the telephone excise tax**

For periods beginning 90 days after enactment of a repeal, the administration’s FY 2016 budget would repeal all federal excise taxes on communications services, including the tax on local telephone service.

### **Increase the standard mileage rate for automobile use by volunteers**

The administration's FY 2016 proposal would set the standard mileage rate for the charitable contribution deduction equal to the rate set by the IRS for purposes of the medical and moving expenses deduction, rather than the statutory limit of 14 cents per mile. The rate would be adjusted annually for inflation.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Consolidate contribution limitations for charitable deductions and extend the carryforward period for excess charitable contribution deduction amounts**

Current law generally limits a donor's charitable contribution deduction to 50% of adjusted gross income (AGI) for contributions of cash to public charities and to 30% for cash contributions to most private foundations. A donor may generally deduct up to 30% of AGI for contributions of appreciated capital gain property to public charities and up to 20% to most private foundations. A donor may deduct up to 20% of AGI for contributions of capital gain property for the use of a charitable organization. Donors generally can carry forward excess amounts for five years; however, contributions of capital gain property for the use of an organization exceeding 20% may not be carried forward.

The administration's FY 2016 proposal would simplify these rules by retaining the 50% limitation for contributions of cash to public charities and replacing the deduction limit for all other contributions with a 30% limitation, regardless of the type of property donated, the type of organization receiving the donation, and whether the contribution is to or for the use of the organization. In addition, the proposal would extend the carryforward period for contributions in excess of these limitations from five years to 15 years.

The proposal would be effective for tax years beginning after December 31, 2015.

### **Exclude from gross income subsidies from public utilities for purchase of water runoff management**

Under current law, subsidies paid to an individual by a water utility for the purchase of water conservation measures would generally be included in the gross income of the individual under section 61.

The proposal would exclude from the gross income of any individual the value of a subsidy provided by a public utility for the purchase of qualifying water conservation or storm water management measures. Qualifying measures include items that reduce water consumption, manage storm water runoff in a dwelling and several other categories.

The proposal would exclude from gross income subsidies provided after December 31, 2015.

### **Provide relief for certain accidental dual citizens**

An individual can become a U.S. citizen at birth either by being born in the United States (or certain territories or possessions) or by having a parent who is a U.S. citizen. Some individuals only become aware when adults of the fact that they have been U.S. citizens since birth. Because U.S. citizens are subject to U.S. income tax on their worldwide income even if they reside abroad, and can also be subject to information reporting obligations, many such individuals wish to relinquish their U.S. citizenship.

Section 877A of the Code imposes a mark-to-market tax on the worldwide assets of individuals who relinquish their U.S. citizenship if they meet a tax liability test (\$160,000 in 2015) a net worth test (\$2 million) or if they fail to certify their compliance with U.S. federal tax obligations for the five preceding tax years.

Section 877A provides an exception from the tax liability and net worth tests for certain dual citizens who have had minimal contacts with the United States during the 15 years preceding the relinquishment of their U.S. citizenship. Such individuals, however, remain subject to the certification test.

The administration's FY 2016 proposal would exempt an individual from tax under section 877A if the taxpayer meets the following conditions:

- The taxpayer became at birth a citizen of the United States and a citizen of another country
- At all times, up to and including the individual's expatriation date, the taxpayer has been a citizen of a country other than the United States
- The taxpayer has not been a resident of the United States (as defined in section 7701(b)) since attaining age 18½ years
- The taxpayer has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with immigration regulations requiring use of a U.S. passport
- The taxpayer relinquishes his U.S. citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he is a U.S. citizen
- The taxpayer certifies under penalty of perjury his compliance with all U.S. federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period

Many dual-citizen individuals living outside the United States could be at risk of penalties under U.S. tax law for failure to disclose their ownership of foreign financial assets by filing annual information returns such as Form 8939, *Statement of Specified Foreign Financial Assets*. These filing obligations generally apply only to U.S. citizens and residents, and not to nonresidents. The administration's proposal would mitigate

this penalty risk by requiring that such individuals only to certify their compliance with the obligations that apply to nonresidents as opposed to the obligations that apply to U.S. citizens and residents.

The proposal would be effective January 1, 2016.

## **USER FEE**

### **Reform inland waterways funding**

For periods beginning after September 30, 2015, the administration's FY 2016 budget would direct the Secretary of the Army to set the amount of a new user fee each year to collect a total of \$1.1 billion from the user fee over the first 10 years. Thereafter, the user fee would be adjusted over time, so that the combined amount collected from the current excise tax and the user fee would cover the user-financed share of spending for inland waterways construction, replacement, expansion, and rehabilitation work, described below. The proposal would also expand the list of waterways subject to the inland waterways excise tax.

Currently, the Inland Waterways Trust Fund is funded by a \$0.29 per gallon excise tax imposed on liquids used as fuel in a vessel in "commercial waterway transportation" on a waterway listed in section 206 of the Inland Waterways Revenue Act of 1978, as amended (describing the inland and intracoastal waterways). Commercial waterway transportation is defined as any use of a vessel on a listed waterway: (1) in the business of transporting property for compensation or hire; or (2) in transporting property in the business of the owner, lessee, or operator of the vessel (other than fish or other aquatic animal life caught on the voyage). Exceptions are provided for deep-draft ocean-going vessels, passenger vessels, state and local governments, and certain ocean-going barges.

The tax and user fee would be dedicated to the Inland Waterways Trust Fund.

## **OTHER INITIATIVES**

### **Allow offset of federal income tax refunds to collect delinquent state income taxes for out-of-state residents**

Generally, an overpayment of federal tax due a taxpayer may be reduced by (i.e., offset by) debts of the taxpayer for past-due child support, debts to federal agencies, fraudulently obtained unemployment compensation, and past-due, legally enforceable state income tax obligations. However, a delinquent taxpayer can escape offset of a federal refund for a state tax liability as long as the taxpayer is not a resident of the state.

The proposal would permit offset of federal refunds to collect state income tax, regardless of where the delinquent taxpayer resides.

The proposal would be effective on the date of enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Authorize the limited sharing of business tax return information to improve the accuracy of important measures of the economy**

Current law authorizes the IRS to disclose certain federal tax information (FTI) for governmental statistical use. However, the Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI and the Bureau of Economic Analysis (BEA) is only authorized for corporate businesses.

The administration's FY 2016 proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than \$250,000 and of all partnerships. BEA contractors would not have access to FTI.

The proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI. In effect, the proposal would allow officers and employees of each of BLS, BEA, and Census Bureau to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves subject to certain restrictions.

The proposal would be effective upon enactment.

This provision was included in the administration's FY 2015 revenue proposal.

### **Eliminate certain reviews conducted by the U.S. Treasury Inspector General for Tax Administration (TIGTA)**

Section 7803(d) requires TIGTA to conduct reviews of certain administrative and civil actions and reviews of the IRS compliance with respect to certain requirements in order to comply with TIGTA's reporting requirements.

As requested by TIGTA, the proposal would eliminate TIGTA's obligation to do statutory reviews that are of relatively low value such as administrative or civil actions related to fair tax collection practices violations in one of TIGTA's semiannual reports, review and certify annually that the IRS is complying with the requirements of section 6103(e)(8) regarding information on joint filers, and annually report on the IRS's compliance with sections 7521(b)(2) and (c) requiring IRS employees to stop a taxpayer interview whenever a taxpayer requests to consult with a representative and to obtain their immediate supervisor's approval to contact the taxpayer instead of the representative if

the representative has unreasonably delayed the completion of an examination or investigation.

The administration's FY 2016 proposal would revise the annual reporting requirement for all remaining provisions in the *IRS Restructuring and Reform Act of 1998* to a biennial reporting requirement.

The proposal would be effective after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

### **Modify indexing to prevent deflationary adjustments**

Under current law, many income tax amounts, brackets, thresholds, and other parameters are indexed for inflation. In some situations, if an inflation index declines, the relevant parameter would decline. In other situations, the parameter would not be reduced if the index declined. In 2008 and 2009, two of the indexes used in adjusting various parameters declined. In one situation, the relevant amount was statutorily held steady; in the other, a dollar limitation declined.

The administration's FY 2016 proposal would modify inflation adjustment provisions so as to prevent any tax parameters from declining from the previous year's levels if the underlying price index falls. Future inflation-related increases would be based on the highest previous level of the price index relevant for adjusting the particular tax parameter.

The proposal would be effective beginning on the date of enactment.



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