



cutting through complexity

# Tax Provisions in Administration's FY 2016 Budget Proposals

## Closely Held Businesses and Their Owners

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## HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET OF INTEREST TO CLOSELY HELD BUSINESSES AND THEIR OWNERS

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016). This booklet highlights selected revenue proposals relevant to closely held businesses and their owners; KPMG has also prepared a 111-page [book](#) that summarizes and makes observations about substantially all the revenue proposals in the Administration's FY 2016 budget. A general review of the budget follows:

Among other things, the president proposed 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. This tax 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 president also proposed 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."

Many of the "general" business tax proposals in the FY 2016 budget are familiar, having been included in previous budgets. These proposals include, for example:

- Limitations on 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

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to

various exceptions and exclusions. Some of these proposed changes are addressed below.

## Proposals of Potential Interest to Closely Held Businesses

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## High Income Business Owners

### **Increase capital gain and qualified dividend rates**

Under current law, capital gains are taxable only on the sale or other disposition of an appreciated asset. The long-term capital gains tax rate (which also applies to qualified dividends) is generally 20% with an additional 3.8% net investment income tax, which may also be applicable on the gain.

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

### **Treat transfers of appreciated property as sales, including transfers on death**

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. When an individual transfers assets during life, the recipient generally receives the assets with a basis equal to the donor's basis in the assets on the date of the gift. There is no recognition of capital gain on the date of death or gift.

The administration's proposal would treat the transfer of appreciated property (during life or at death) as a sale of the property, with any inherent gain realized and subjected to capital gains tax at that time. Tax incurred on gains deemed realized at death would be deductible for estate tax purposes. Transfers to a spouse or to a charity would not trigger the capital gains tax and would instead carry over the basis of the donor or decedent to the recipient. In addition, the proposal would exempt any gain on tangible personal property (items like furniture, clothing and other household items) other than art and similar collectibles, exempt up to \$250,000 per person of gain on a residence, and exempt up to \$100,000 per person (indexed for inflation) of other gain. The residence and general exemptions would be portable between spouses such that couples could collectively exempt \$500,000 of gain on a residence and \$200,000 of other gain.

The exclusion under current law for capital gain on certain small business stock would also apply. The proposal makes tax due on the gain attributable to certain small family-owned and family-operated businesses only once they are actually sold or cease to be family-owned and operated. 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 gains on gifts made and for decedents dying after December 31, 2015.

## **KPMG observation**

This is a new provision, i.e., it was 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 contemplated a corresponding elimination of the estate tax (i.e., suggesting that there should be an estate tax or a capital gains tax at death but not both). This proposal, however, does not appear to affect the existence of the estate tax and seems to contemplate its continuing applicability by allowing for the capital gains taxes triggered at death to be taken as a deduction on the decedent’s estate tax return. If this provision and the provision seeking to return the estate tax provisions back to 2009 levels were both 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%, plus, where applicable, state estate and state income taxes. While the interplay of the various taxes is not completely spelled out in detail in the proposal, it is conceivable that, in a high tax state, zero basis assets held at death could bear a total tax of 70-75% (taking into account the potential deductibility of the capital gains tax on the estate tax return).

## **Impose a new “minimum” tax on higher income taxpayers**

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.

### **Reduce amounts of itemized deductions**

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 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.

## **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.

## **Estate & Gift**

### **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.

## Compensation & Benefits

### **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.

### **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.

### **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.

### **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.

### **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.

## Partnership-related Items

### **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.

### **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.

### **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.

## **Business Incentives**

### **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.

### **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.

### **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.

#### **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.

### **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.

### **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.

### **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.

### **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.

## **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.

## **Other Business Tax Items**

### **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.

### **Reinstate corporate environmental income tax rate**

The administration's FY 2016 budget would 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 tax would be dedicated to the Hazardous Substance Superfund Trust Fund.

### **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).”

### **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.

### **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 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.

### **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).

## **Compliance Items**

### **Improve Compliance by Businesses/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.

#### **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.

#### *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.

#### **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.

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