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Tax Provisions in Administration's FY 2016 Budget Proposals

Charitable Deductions & Exempt Organizations

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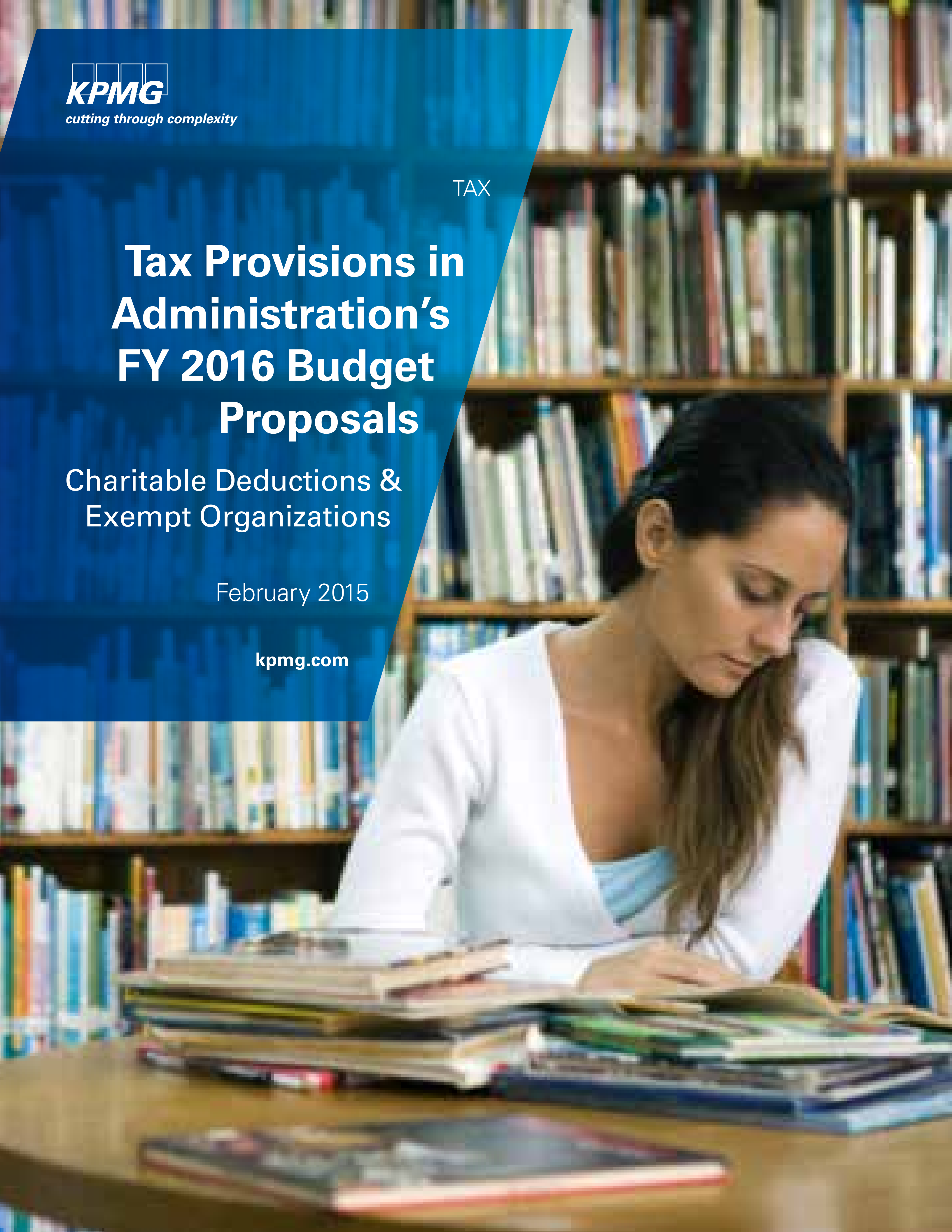

HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO CHARITABLE DEDUCTIONS AND EXEMPT ORGANIZATIONS

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals relating to Charitable Deductions and Exempt Organizations. Other booklets will address proposals relating to the following topics:

- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Financial Institutions & Products
- Passthrough Entities
- Practice, Procedures, & Administration
- Compensation, Benefits, & Qualified Plans
- Energy & Natural Resources
- Insurance
- Real Estate
- Taxation of Individuals

Background

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).

Among many 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 raised in previous budgets. These proposals include, for example:

- Reforms to the international tax system
- 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
- Denial of 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

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 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 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. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

Charitable Deductions and Exempt Organizations Tax Proposals

This booklet addresses the following budget proposals:

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.

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.

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.

Modify tuition reporting requirements

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.

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.

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.

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).

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.

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.

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.

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" (rather than "to") 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.

Modify Tax-Exempt Bond Provisions

The budget proposal contains a number of provisions that would impact tax-exempt bonds, including the following:

- Provide America Fast Forward Bonds and expand eligible uses
- Allow current refundings of state and local governmental bonds
- Provide a new category of qualified private activity bonds for infrastructure projects referred to as "Qualified Public Infrastructure Bonds"
- Modify qualified private activity bonds for public educational facilities
- Repeal tax-exempt bond financing of professional sports facilities
- Modify tax-exempt bonds for Indian tribal governments
- 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

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