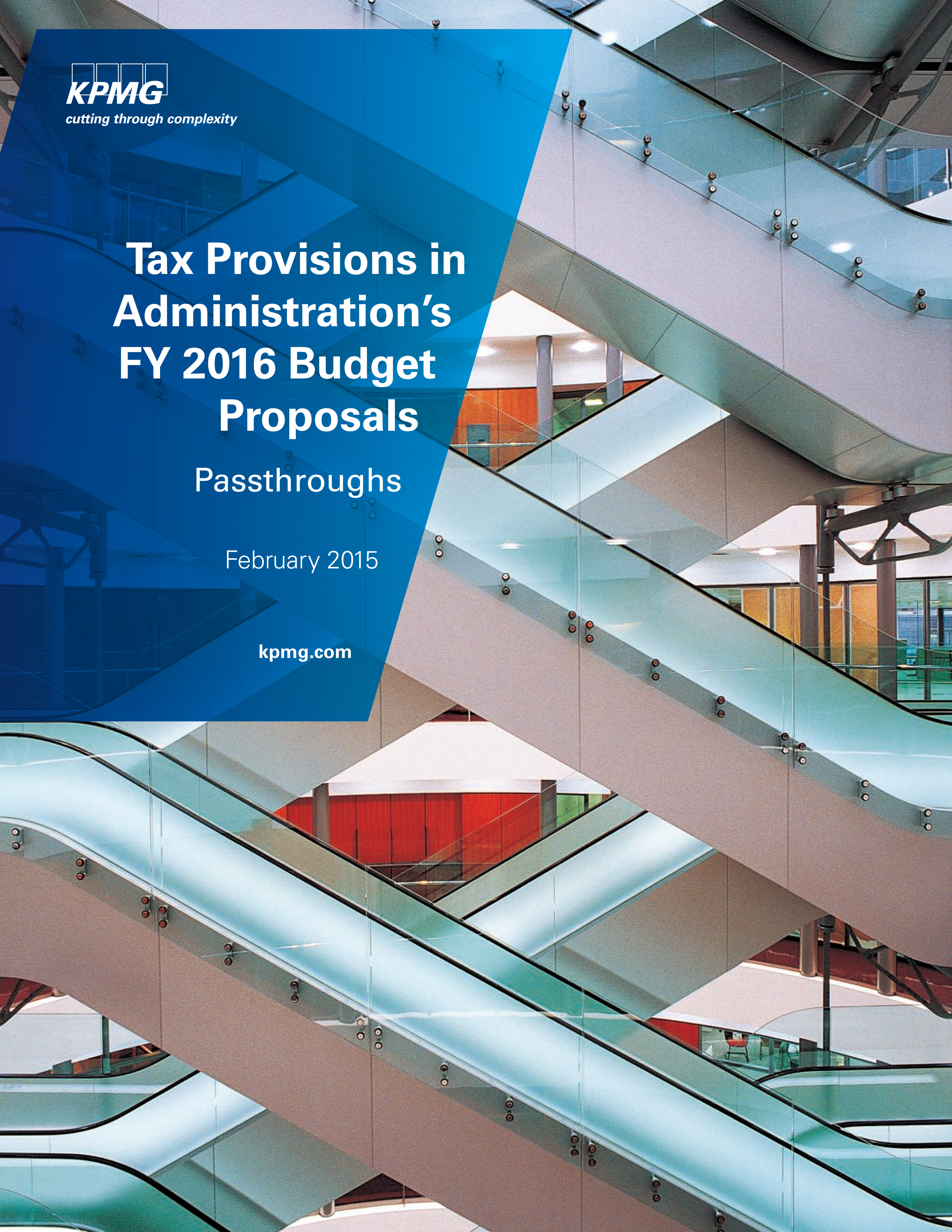

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Tax Provisions in Administration's FY 2016 Budget Proposals

Passthroughs

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO PASSTHROUGH ENTITIES

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 passthrough entities. Other booklets will address proposals relating to the following topics:

- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Financial Institutions & Products
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Compensation, Benefits, & Qualified Plans
- Energy & Natural Resources
- Insurance
- Real Estate
- Taxation of Individuals
- Closely-Held Businesses and Their Owners

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 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." Also, although the budget includes proposed incentives for certain small businesses, it does not propose lowering the rates at which individual owners of passthrough entities would pay tax on flowthrough income.

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
- 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 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. Because passthrough entities generally are taxed at the owner level, some of the proposed changes to the individual tax rules are highlighted in this booklet.

Passthrough Entities Tax Proposals

This booklet addresses the following budget proposals:

Modifications of Partnership Tax Rules

Deny publicly traded partnership (PTP) status for fossil fuel activities

Section 7704 provides that certain partnerships may be publicly traded entities while maintaining passthrough status. These entities are not subject to corporate tax.

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

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

KPMG observation

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

Notably, the *Tax Reform Act of 2014* proposed by the former Chairman of the House Ways and Means Committee, Dave Camp, in the last congress also included narrowing the scope of the PTP rules. However, the Camp tax reform bill would have required financial services PTPs to be classified as corporations, but would have allowed fossil fuel PTPs to maintain passthrough status.

Treat income from certain carried (profits) interests as ordinary

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, however, reflects a different approach than that taken in the Camp tax reform bill.

The Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—generally indicates that the 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 partnership technical termination rules

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.

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.

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 A; 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

Tax gain from the sale of a partnership interest as "ECI" on look-through basis

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

Modification to Employment Tax Rules for Passthrough Entities

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.

Modification to REIT Rules

Repeal preferential dividend rule for publicly traded and publicly offered real estate investment trusts (REITs)

The administration's FY 2016 budget proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

- As of the record date of the distribution, the REIT was publicly traded
- As of the record date of the distribution—
    - The REIT was required to file annual and periodic reports with the SEC under the Securities Act of 1934
    - Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318)
    - Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period

Treasury would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule when it continues to apply and, when appropriate, to require consistent treatment of shareholders.

The provision would apply to distributions that are made (without regard to section 858) in tax years beginning after the date of enactment.

Compliance Changes

Streamline audit and adjustment procedures for large partnerships

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

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

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

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

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

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

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

KPMG observation

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

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

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

Change return filing due dates

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 15th 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 15th 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.

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.

Authorize the limited sharing of partnership tax return information

Current law authorizes the IRS to disclose certain federal tax information (FTI) for governmental statistical use. However, the Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI and the Bureau of Economic Analysis (BEA) is only authorized for corporate businesses.

The administration's FY 2016 proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than $250,000 and of all partnerships. BEA contractors would not have access to FTI.

The proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI. In effect, the proposal would allow officers and employees of each of BLS, BEA, and Census Bureau to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves subject to certain restrictions.

The proposal would be effective upon enactment.

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

Selected Changes to Individual Tax Rules

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 "fair share tax" on upper-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.

The 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.

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