



Tax Provisions in the Administration's FY 2017 Budget

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EXECUTIVE SUMMARY OF TAX PROPOSALS IN FY 2017 BUDGET

President Obama on February 9, 2016, transmitted to Congress his fiscal year (FY) 2017 budget, containing the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2016. Although it is not expected that Congress will enact—or even vote on—the president's budget as a whole, the budget represents the administration's view of the optimum direction of spending and revenue policy.

Overview

The president proposes expenditures of \$4.147 trillion. Expenditures would adhere to the sequestration caps of the *Budget Control Act of 2011*, as modified last Fall by the *Bipartisan Budget Act of 2015*, although the budget anticipates lifting the caps in future years.

The budget would, according to the White House, reduce the deficit by \$2.9 trillion over 10 years. More than \$900 billion of that reduction would be attributable to changes in the taxation of capital gains and the reduction of tax benefits for upper income individuals. It would also be achieved through changes in the taxation of international business income (which would raise almost \$800 billion in new revenue over 10 years), and from other business tax changes (which would raise approximately \$337 billion).

The president also proposes to impose a new fee on oil that would raise almost \$320 billion over 10 years. That new revenue would be committed to investment in transportation information infrastructure as part of a multi-agency initiative to build a “clean” transportation system less reliant on carbon-producing fuels.

The budget also reiterates the president's goal of cutting the corporate tax rate and making structural changes and closing loopholes. In *The President's Framework for Business Tax Reform* (February 2012), he proposed cutting the corporate rate to 28%. The budget does not, however, provide sufficient revenue to offset the cost of such a rate reduction.

Business tax proposals

Many other tax proposals in the FY 2017 budget are familiar, having been included in previous budgets, such as:

- Reforms to the international tax system
- Limiting the ability of domestic entities to expatriate
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income

- Insurance industry reforms
- Marking financial derivatives to market and treating gain as ordinary income
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages

Some previous proposals have been modified significantly, such as expanding the types of property subject to a proposed change to the like-kind exchange rules.

The budget also includes a proposal from last year's budget to impose a tax on the liabilities of financial institutions with assets in excess of \$50 billion of 7 basis points.

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

As part of the transition to the new system of taxation of foreign earnings, the budget would also impose a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to U.S. tax.

Individual (personal) tax revisions

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

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the so-called "Buffett Rule") of 30% of AGI
- Limit the total accrual of tax-advantaged retirement benefits
- Restore the estate, gift, and GST parameters to those in effect in 2009

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

The highest tax on capital gains would be increased from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, the Green Book* indicates that a transfer of appreciated property would generally be treated as a sale of the property. Thus, the donor or deceased owner of an appreciated asset would be subject to capital gains tax on the excess of the asset's fair market value on the date of the transfer over the transferor's basis.

The budget also includes a proposal to expand the definition of net investment income to include gross income and gain from any trades or businesses of an individual that is not otherwise subject to employment taxes. The change would potentially affect limited partners and members of LLCs, as well as S corporation owners.

In response to concern that employees in employer-sponsored health plans might unfairly become subject to the Affordable Care Act's excise tax on high-cost plans because they reside in states where health care costs are higher than the national average, the president proposes modifying the threshold for application of the tax. The proposal would increase the threshold to the greater of the current law threshold or a "gold plan average premium" calculated for each state. (The tax currently is scheduled to be effective beginning in 2020.)

Treasury's explanation

The Treasury Department on February 9 released an accompanying explanation of the tax proposals of the budget—Treasury's [Green Book*](#) [PDF 1.57 MB]—which describes those proposals in greater detail.

*General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals

User's guide

\$ = U.S. dollar

% = percent

PATH Act = Protecting Americans from Tax Hikes Act of 2015 (enacted December 18, 2015)

Green Book = Treasury's *General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals*

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REVENUE PROPOSALS

ELEMENTS OF BUSINESS TAX REFORM

Reform the U.S. international tax system

The administration's FY 2017 budget proposals aim at reforming the U.S. international tax system remain largely unchanged from previous years' budgets. The FY 2017 proposals do not make any substantive changes to the FY 2016 proposals, other than: (1) removing the proposals that have already been enacted in prior legislation (e.g., the permanent extension of the subpart F active financing exception and the exemption from FIRPTA for qualified foreign pension funds, both enacted in the PATH Act); and (2) updating the effective dates for the various proposals.

Restrict deductions for excessive interest of members of financial reporting groups

Under the FY 2017 proposal, the U.S. interest expense deduction of any member of a group that prepares consolidated financial statements in accordance with U.S. GAAP, IFRS, or other method authorized by the Secretary under regulations ("financial reporting group") would be limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles (based on the member's proportionate share of the group's earnings as reflected in the group's financial statements). U.S. subgroups would be treated as a single member of a financial reporting group for purposes of applying the proposal.

If a member fails to substantiate its proportionate share of the group's net interest expense, or a member so elects, the member's interest deduction would be limited to 10% of the member's adjusted taxable income (as defined under section 163(j)). Any disallowed interest would be carried forward indefinitely and any excess limitation for a tax year would be carried forward to the three subsequent tax years. A member of a financial reporting group that is subject to the proposal would be exempt from the application of section 163(j).

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than \$5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a tax year. Entities that are exempt from this proposal would remain subject to section 163(j).

The proposal would be effective for tax years beginning after December 31, 2016.

KPMG observation

The proposal is intended to address the use by multinational groups of debt to inappropriately shift profits to lower tax jurisdictions and, unlike section 163(j), considers the leverage of a multinational group's U.S. operations relative to its worldwide operations.

In addition, unlike other proposals (discussed below) that are focused primarily on the foreign activities of U.S. multinationals, this proposal appears principally intended to limit foreign-owned multinationals from disproportionately claiming interest expense against their U.S. income tax liability as compared to their tax liabilities elsewhere in the world.

Provide tax incentives for locating jobs and business activity in the U.S. and remove tax deductions for shipping jobs overseas

The administration's FY 2017 proposal would create a new general business credit against income tax equal to 20% of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. Any creditable costs incurred by a foreign subsidiary would allow a tax credit to be claimed by the U.S. parent company.

In addition, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business, i.e., related to reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign company (CFC), no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

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

KPMG observation

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

Repeal delay in the implementation of worldwide interest allocation

The administration's FY 2017 budget proposal would accelerate the availability of the worldwide affiliated group election for allocating interest expense to tax years beginning after December 31, 2016. The Green Book states that accelerating the availability of the election would allow taxpayers to more accurately allocate and apportion interest expense for all purposes for which the allocation is relevant, including for implementing the new minimum tax proposal discussed below.

Impose a 19% minimum tax on foreign income

The administration's FY 2017 proposal would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). The minimum tax would apply to a U.S. corporation that is a U.S. shareholder of a CFC or that has foreign earnings from a branch or from the performance of services outside the United States. Under the proposal, a foreign branch of a U.S. corporation would be treated like a CFC. The foreign earnings subject to the proposal would be subject to current U.S. taxation at a rate of 19% less 85% of the per-country foreign effective tax rate (the "residual minimum tax rate").

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

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

The minimum tax for a particular country would be computed by multiplying the applicable residual minimum tax rate by the minimum tax base for that country. A U.S. corporation's minimum tax base for a country for a tax year would be the total amount of foreign earnings for the tax year assigned to that country, reduced by an allowance for corporate equity (ACE). The ACE provision would provide a risk-free return on equity invested in active assets and is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.

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

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

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

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

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual

minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

The Secretary would be granted authority to issue regulations to carry out the purposes of the minimum tax, including regulations addressing the taxation of undistributed earnings when a U.S. corporation owns an interest in a foreign corporation that has a change in CFC status, and regulations to prevent the avoidance of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

Lastly, the administration's FY 2017 budget would make permanent the temporary subpart F "look-through" exception in section 954(c)(6) for certain payments between related CFCs and subject any income qualifying under the look-through exception to the minimum 19% tax.

These proposals would be effective for tax years beginning after December 31, 2016.

KPMG observation

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

The minimum tax coupled with the ACE allowance is conceptually similar to the minimum tax proposal in former Ways and Means Chairman Camp's 2014 tax reform bill. Very generally, the Camp tax reform bill would have imposed a minimum tax of 15% on a CFC's foreign earnings by creating a new category of subpart F income (foreign base company intangible income or FBCII) for foreign earnings subject to an effective tax rate below 15%. Like the administration's ACE, the Camp tax reform bill excluded from the FBCII tax base a specified percentage (in the Camp tax reform bill, 10%) of the CFC's qualified business asset investment, which was defined by Camp as the aggregate adjusted basis of certain tangible depreciable property used in the CFC's trade or business. It is not clear how the ACE allowance would be determined under the administration's minimum tax provision.

The minimum tax proposal also includes several new concepts and raises a number of

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

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

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

The administration's FY 2017 budget proposal would impose a one-time 14% tax on a CFC's accumulated earnings that were not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such untaxed earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate rate for 2016. Any untaxed CFC earnings subject to this one-time tax could then be repatriated without any additional U.S. tax liability. The tax due under this proposal would be payable ratably over five years. This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning no later than December 31, 2016.

KPMG observation

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

Limit shifting of income through intangible property transfers

The administration's FY 2017 budget proposes that the definition of intangible property for purposes of sections 367(d) and 482 include workforce-in-place, goodwill, and going-concern value, and adds "any other item owned or controlled by a taxpayer that is not a tangible or financial asset and that has substantial value independent of the services of any individual." The FY 2017 proposal is not presented as a clarification of existing law and specifically states that no inference is intended under current law.

In addition, the FY 2017 proposal provides that the IRS may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by

choosing a realistic alternative to the controlled transaction undertaken, and when multiple intangible properties are transferred, the IRS may value the intangible properties on an aggregate basis when that achieves a more reliable result.

The proposal would be effective for tax years beginning after December 31, 2016.

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

The administration's FY 2017 proposal would: (1) deny an insurance company a deduction for reinsurance premiums for property and casualty risks paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes.

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

The provision would be effective for policies issued in tax years beginning after December 31, 2016.

KPMG observation

Similar proposals have been made in the last four budget proposals. The FY 2017 proposal, like the FY 2016 proposal, would limit the disallowance to property and casualty reinsurance premiums, making it consistent with former Ways and Means Chairman Camp's tax reform bill (February 2014).

This provision was included in the administration's FY 2012 through 2016 revenue proposals.

Modify tax rules for dual capacity taxpayers

The administration's FY 2017 proposal would cap a dual-capacity taxpayer's foreign tax credit from a jurisdiction at the amount of tax the dual-capacity taxpayer would pay in that

jurisdiction if it were not a dual-capacity taxpayer (i.e., subject to the generally applicable income tax laws). This provision would not override any treaty that explicitly allows a credit for taxes to be effective for amounts that, if such amounts were an amount of tax paid or accrued, would be considered paid or accrued in tax years beginning after December 31, 2016.

The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income.

KPMG observation

Some observers note that the proposal could produce a harsh result—zero foreign tax credits—for dual-capacity taxpayers operating in foreign jurisdictions that do not generally impose an income tax.

The dual-capacity taxpayer rules apply primarily to oil and gas producers, but also may apply to other businesses, e.g., a corporation loaning money to a foreign government or a government contractor.

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

The FY 2017 proposal would characterize gain or loss from the sale or exchange of a partnership interest as income effectively connected with the conduct of a trade or business in the United States (ECI) to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

The proposal would also provide a collection mechanism in the form of gross basis withholding. The transferee of a partnership interest would be required to withhold 10% of the amount realized by the foreign partner on the sale or exchange of a partnership interest, unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. Alternatively, if a transferor provided a certificate from the IRS that established that the transferor's federal income tax liability with respect to the transfer was less than 10% of the amount realized, the transferee would withhold such lesser amount. If the transferee failed to withhold the correct amount, the partnership would be liable for the amount of under-withholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

This proposal would be effective for sales or exchanges after December 31, 2016.

KPMG observation

The proposal would codify a longstanding IRS position set out in Rev. Rul. 91-32.

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

The administration's FY 2017 proposal would extend the application of section 338(h)(16) to any covered asset acquisition (within the meaning of section 901(m)) and remove foreign taxes from a section 902 corporation's foreign tax pool in the event of a transaction that results in the reduction, allocation, or elimination of a foreign corporation's earnings and profits other than by reason of a dividend or a section 381 transaction. The amount of foreign taxes that would be reduced in this type of transaction would equal the amount of foreign taxes associated with the eliminated earnings and profits. The proposal would be effective for transactions occurring after December 31, 2016.

KPMG observation

This provision extends the reach of section 338(h)(16), which requires the calculation of the source and character of items for foreign tax credit purposes to be made without taking into account the impact of a section 338 election, to all covered asset acquisitions, as defined in section 901(m).

This provision would extend the general principle that, for purposes of calculating the foreign tax credit allowable in the United States, the source and character of income would be determined by treating acquisitions made by a taxpayer in a manner consistent with their treatment under foreign law. Thus, to the extent foreign law would treat an acquisition as a purchase of stock, for purposes of calculating the foreign tax credit limitation, items relating to that purchase would be sourced as though the purchase were a stock purchase. In the case of a U.S. seller, this would result in all items of income or expense originating from assets acquired in a transaction covered by section 901(m) being treated for foreign tax credit purposes as domestic source capital gains or losses, regardless of the source and character they would otherwise have.

To the extent that current law adjusts foreign tax pools only on account of dividends and subpart F inclusions, it can have the effect of separating foreign taxes from the income to which they relate. Thus, to some extent, this proposal could be viewed as a further (albeit very narrow) extension of the principles underlying section 909.

Close loopholes under subpart F

The administration's FY 2017 proposals would create a new category of subpart F income for digital income and expand the foreign base company sales income rules to include income related to manufacturing services arrangements.

The administration's FY 2017 budget proposal would create a new category of subpart F income—foreign base company digital income (FBCDI)—which generally would include income of a CFC from the lease or sale of a digital copyrighted article or from the provision of a digital service. The FBCDI provision would apply in cases when the CFC uses intangible property developed by a related party (including property developed pursuant to a cost sharing arrangement) to produce the income. An exception would apply if the CFC, through its own employees, makes a substantial contribution to the development of the property or services that give rise to the income. Another exception would apply when the CFC earns income directly from customers located in the CFC's country of incorporation that use or consume the digital good or service in such country.

The FY 2017 budget proposal would expand the category of foreign base company sales income (FBCSI) to include income of a CFC from the sale of property manufactured on behalf of the CFC by a related person. The existing exceptions to foreign base company sales income would continue to apply.

In addition, the administration's FY 2017 proposal includes two provisions that would modify the thresholds for applying subpart F in two ways. First, for purposes of determining whether a foreign corporation is a CFC and a U.S. person is a U.S. shareholder of a CFC, the proposal would amend the ownership attribution rules of section 958(b) to attribute stock of a foreign corporation from a foreign person to a related U.S. person. However, the pro rata share of a CFC's subpart F income that a U.S. shareholder is required to include in gross income would continue to be determined based on direct or indirect ownership of the CFC, without application of section 958(b).

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

These proposals would be effective for tax years beginning after December 31, 2016.

KPMG observation

Akin to other foreign base company income provisions, the FBCDI rule would apply in a related-party context and would target income that is both mobile (i.e., when lease, sale, or service is provided for customers outside of the CFC's country of incorporation) and passive (i.e., when the CFC does not substantially contribute to the development of income producing property or services).

Indeed, according to the Treasury, the provision is intended to address shifting of mobile income earned from providing digital goods and services to low-tax jurisdictions (and related base erosion) and prevent avoidance of subpart F rules through choosing different forms (leases, sales, or services) for substantially similar digital transactions.

As an example of a digital transaction, Treasury mentions a transfer of a computer program (a copyrighted article) characterized as a sale or a lease, as well as a computer program hosted on a server used in a transaction characterized as the provision of a service to a user who accesses the server from a remote location. As an example of a problematic digital transaction, Treasury mentioned a CFC conducting business with remotely located customers through the “cloud” using intangible property acquired from a related party and without conducting any substantial business activities of its own.

Treasury has taken the view that taxpayers have been attempting to avoid FBCSI by using a CFC that “obtains the property that the CFC sells to customers as the provision of a manufacturing service to the CFC rather than as a purchase of the property by the CFC” (and that in some cases, taxpayers take this position with respect to property produced in the United States on behalf of a related CFC). Yet, as the Treasury points out, the policy concerns that underlie the FBCSI rules (and concerns about related U.S. base erosion) apply—with respect to income earned by a CFC from the sale of property produced by a related party—regardless of whether the CFC is characterized as obtaining the property through a purchase transaction or through a manufacturing service.

The proposal addresses a transaction structured as a purchase, by the CFC, of materials from an unrelated person and a sale of manufactured goods to an unrelated person (for use outside the country of CFC’s incorporation) in a case when the CFC engages a related person to manufacture (outside the country of CFC’s incorporation) the goods on the CFC’s behalf and when the CFC does not substantially contribute to such manufacturing.

In such a case, (1) the current FBCSI provisions would generally not apply because the purchase and sale of personal property involve only unrelated persons; and (2) the branch rule would not apply because the related contract manufacturing facility generally would not amount to a manufacturing branch of the CFC. In effect, this rule would legislatively reinstate the position of the IRS in Rev. Rul. 75-7 that was rejected by the U.S. Tax Court in 1990 in the *Ashland* and *Vetco* cases.

Restrict the use of hybrid arrangements that create stateless income

The administration’s FY 2017 proposal would deny deductions for interest and royalty payments made to related parties under hybrid arrangements that give rise to income that is not taxed in any jurisdiction (stateless income). The Treasury Secretary would be granted

authority to issue regulations to carry out the stated purpose of this proposal. The regulations would include rules that:

- Deny deductions from certain conduit arrangements that involve hybrid arrangements between at least two of the parties to the arrangement;
- Deny interest and royalties deductions arising from certain hybrid arrangements involving unrelated parties in appropriate circumstances, for example structured transactions; and
- Deny all or a portion of a deduction claimed with respect to an interest or royalty payment that, as a result of the hybrid arrangement is subject to inclusion in the recipient's jurisdiction pursuant to a preferential regime that has the effect of reducing the generally applicable statutory rate by at least 25%.

This proposal, as an example, is intended to deny a deduction to a U.S. taxpayer upon an interest or royalty payment to a related party and either: (1) under a hybrid arrangement there is no corresponding income inclusion for the recipient in the foreign jurisdiction; or (2) a hybrid arrangement would permit a taxpayer to claim an additional deduction for the same payment in another jurisdiction.

The proposal also includes a provision that makes sections 954(c)(3) (the subpart F "same-country exception") and 954(c)(6) (the subpart F "controlled foreign corporation look-through rules") inapplicable to payments made to a foreign reverse hybrid held directly by a U.S. owner when such amounts are treated as deductible payments received from foreign related persons.

This proposal would be effective for tax years beginning after December 31, 2016.

Limit the ability of domestic entities to expatriate

The proposal would broaden the definition of an inversion transaction by replacing the 80% test in section 7874 with a greater than 50% test, and it would eliminate the 60% test. The proposal would also provide that an inversion transaction would occur—regardless of the level of shareholder continuity—if:

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

corporation is created or organized.

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

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

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

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

KPMG observation

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

This proposed change is intended to address the fact that domestic entities have been combining with smaller foreign entities resulting in a continued ownership being less than 80% (although more than 60%). Treasury stated:

"The adverse tax consequences under current law of 60-percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base."

Additionally, under the proposal, a foreign corporation's acquisition of a domestic entity could be treated as an inversion—even if there is no ownership continuity—if (1) immediately prior to the transaction, the domestic entity's fair market value is greater than the foreign acquiring corporation's fair market value, and (2) the foreign acquiring corporation's expanded affiliated group (A) is primarily managed and controlled in the United States, and (B) does not conduct substantial business activities in the foreign acquiring corporation's country of creation or organization. Treasury stated that, under these circumstances, the transaction would still be considered an inversion, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group. Thus, it appears that an inversion could occur under this special rule when a foreign corporation purchases the domestic entity's ownership interests for cash and none of the domestic entity's former holders roll into the foreign corporation—i.e., all the former holders cash out of their investment or some of the former holders cash out and others choose to retain their direct investment in the domestic entity.

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

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

Although not part of the inversion proposal, the proposed modifications to section 958(b) and the definition of a CFC (discussed above) could have a significant impact on foreign-parented groups that include a U.S. corporation with its own foreign subsidiaries, including companies that have successfully “inverted” in the past.

Simplification and tax relief for small business

Expand expensing for small business

The administration's FY 2017 proposal would increase the 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 2015 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. The deduction limits and thresholds for section 179 expensing were made permanent by the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).

The FY 2017 proposal would increase the expensing limitation to \$1 million for qualifying property placed in service in tax years beginning after 2016, 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. However, the \$35,000 increase to the expensing limit for enterprise zone businesses would not be indexed given that the FY 2017 budget proposes to replace the empowerment zone expensing provisions under section 179 with a 100% bonus depreciation provision for Promise Zones (described below).

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

Certain businesses must use an accrual method of accounting, including C corporations, a partnership 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. 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 2017 proposal would create a uniform small business threshold at \$25 million in average annual gross receipts for the prior three tax years for 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:

- Use of the cash method of accounting in lieu of an accrual method (regardless of whether the entity holds inventories)
- The non-application of the uniform capitalization (UNICAP) rules
- 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 the average annual gross receipts of which 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 corporation 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, 2016, and the threshold would be indexed for inflation with respect to tax years beginning after December 31, 2017.

The Green Book indicates 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 administration's FY 2017 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 2016.

Current law generally 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.

Similarly, current law generally 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 2017 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 Green Book indicates that a permanent doubling of currently deductible start-up expenses would support new business formation and job creation, and consolidating the provisions relating to expenditures incurred by new businesses would simplify tax administration and reduce new business owners' tax compliance burden.

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

Substantially similar to last year's proposal, the administration's FY 2017 proposal would expand the group of employers that are eligible for this 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, 2015.

Incentives for job creation, manufacturing, research, and clean energy

Enhance and simplify research incentives

The PATH Act made the research credit permanent, with taxpayers given two alternative methods of computing the research credit. The FY 2017 budget proposal would repeal the so-called traditional method, leaving the Alternative Simplified Credit (ASC) as the only available method. The rate of the ASC, imposed on incremental research spending in excess of a base amount, would be increased from 14% to 18%, and a special rule for start-up companies that allowed them a flat rate credit of 6% of current year research spending would be repealed. The PATH Act allows certain small taxpayers to use their research credits against alternative minimum tax liability; the budget proposal would allow all taxpayers to do so. Seventy-five percent (75%), rather than the general 65%, of certain contract research payments to non-profit organizations (e.g., educational institutions) would be counted as research expenses in computing the credit. Also, the budget proposal would repeal rules that have limited the ability of an individual partner in a partnership or

an S corporation shareholder to use a credit generated by the entity. Instead, they would be limited to offsetting the tax on the income generated by the entity for the year. In addition, individual taxpayers would no longer need to deduct their research expenditures over 10 years in computing alternative minimum tax.

The changes would be effective for research expenditures paid or incurred after 2016.

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

The Work Opportunity Credit (WOTC), which allows a credit to employers for the first-year wages paid to employees in targeted groups, would be made permanent, past its current reach of applying to employees who begin work before January 1, 2020. The targeted group of qualified veterans would be expanded for individuals who begin work after 2016 to include disabled veterans who use G.I. Bill benefits for training within one year after discharge, who are hired within six months after ending their training. The first \$12,000 of wages paid these veterans would be eligible for the WOTC.

A credit allowed for wages paid to individuals who are members of Indian tribes (and their spouses) and who, generally, live and work on a reservation, would be made permanent, past its current termination at the end of 2016. In tax years after 2016, the credit would be 20% of the amount of qualified wages and health insurance costs for an employee in excess of the average amount for the two preceding tax years.

Provide new manufacturing communities tax credit

Similar to last year's budget proposal, the administration's FY 2017 proposal would create a new allocated tax credit to support investments in communities that have suffered a major job loss event. The Green Book explains that 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 have to consult with relevant state or local economic development agencies (or similar entities) in selecting 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, 2017 through 2019.

Provide community college partnership tax credit

The administration's FY 2017 budget includes a proposal for a new "general business credit" that would provide \$500 million in tax credit authority for each of the five years 2017 through

2021, which would be allocated to states on a per capita basis and ultimately awarded to employers who hire graduates of community and technical colleges on a full-time and permanent basis. Credits allocated to a state but unused in a given year would be reallocated among the states in the following year. A designated state agency would competitively award credit authority to qualifying community and technical college consortia, and certify employer participation and eligibility to claim the credit. Qualifying employers would receive a one-time \$5,000 tax credit for each qualifying employee hired. The credit would be partially recaptured if the employee worked less than one year.

The administration proposes to work with state agencies on many details of the credit. Award criteria to be used by state agencies would be designed to “encourage partnerships focused on education and training pathways to get low-income and disadvantaged students the skills for better paying jobs.” The administration provides examples of the contributions the state agencies would require employers to make in order to be eligible to claim the credit, such as curricula development, internships and applied learning opportunities, registered apprenticeship programs, and provision of labs.

KPMG observation

The proposal provides a basic framework for the credit, including rules to determine when the credit may be claimed by an employer and how credit authority will be allocated among the states. However, the proposal does not provide much detail with respect to the mechanics of the award process, which may be understandable given the envisioned participation by state agencies.

Designate promise zones

Similar to last year’s budget proposal, the administration’s FY 2017 proposal would provide tax incentives to businesses that employ zone residents or place into service property within the zone. The administration has already designated 13 areas as promise zones and intends to designate another seven in Spring of 2016. The administration’s FY 2017 proposal is thus solely related to proposed tax incentives.

The first proposed tax incentive is to provide an employment credit to businesses that employ zone residents. The credit would apply to the first \$15,000 of annual qualifying zone employee wages at a credit rate of 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.

The second proposed tax incentive is to allow first-year depreciation of 100% of the adjusted basis of qualified property that is placed in service within the zone. Qualified property

includes tangible property with a recovery period of 20 years or less, water utility property, certain computer software, and qualified leasehold improvement property.

For the purpose of the tax incentives, zone designations would be in effect from January 1, 2017, through December 31, 2026.

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

The administration's FY 2017 proposal includes a proposal that is substantially similar to its FY 2016 proposal, to make permanent the production tax credit (at current rates, adjusted annually for inflation), make the production tax credit refundable, eliminate the third-party sales requirement for production tax credit eligibility, make permanent the investment tax credit (under terms available to sources in 2017), and make permanent the election to claim the investment tax credit in lieu of the production tax credit. The proposal also would allow solar facilities to qualify for the production tax credit for construction that begins after 2016, and allow individuals who install solar property on a dwelling unit before 2022 to claim the production tax credit in lieu of the residential energy efficient property credit; if installed after 2021, the individuals may claim only a production tax credit.

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 expires on December 31, 2016.

The proposal would permanently extend the current law and update the benchmarking standard to apply Standard 90.1-2010 (current law applies Standard 90.1-2013 which is a more rigorous standard).

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 2017, for projected energy savings from retrofitting existing commercial buildings with at least 10 years of occupancy. A taxpayer could only take one deduction for each commercial building property.

KPMG observation

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

Provide a carbon dioxide investment and sequestration tax credit

Current law allows a tax credit to taxpayers that sequester carbon dioxide (CO₂) emissions. The credit is equal to \$20 per metric ton if the CO₂ is properly stored and \$10 per ton if it is used as a tertiary injectant in an enhanced oil or natural gas recovery project. The credit is available through the tax year in which an aggregate of 75 million tons has been sequestered. The credit is indexed for inflation.

To facilitate technological advances that will assist in controlling future greenhouse gas emissions, the administration's FY 2017 budget proposes that \$2B be allocated as a new refundable investment tax credit to projects that capture and permanently sequester at least one million metric tons of CO₂ per year. Both new and retrofitted electric generating units would be eligible. Projects that treat the entire flue gas stream from an electric generating unit must sequester at least 50% of the CO₂ in the stream, while projects that treat only a portion of the flue gas stream must capture at least 80%.

The investment tax credit is for 30% of the installed cost of carbon capture equipment and other tangible property used as an integral part of the project and CO₂ transportation and storage infrastructure. The property must be placed in service after December 31, 2015.

The investment tax credit would be allocated to applicants, based on numerous specified factors, for all or part of their qualified investment. Not more than \$800 million of credits would be allowed to flow to projects that capture and store less than 80% of their CO₂ emissions. At least 70% of the credits would be required to flow to projects fueled by greater than 75% coal. Applications would be due two years after the date of enactment, and the allocations would occur after that.

The proposal would also provide a new, refundable sequestration credit, \$10 per metric ton

of CO₂ if permanently sequestered and beneficially used, such as in an enhanced oil recovery operation, and \$50 per metric ton if permanently sequestered and not beneficially reused. The credit would be allowed for a maximum of 20 years of production. The rate would be indexed for inflation.

The proposal would be effective after the date of enactment.

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

The administration's FY 2017 proposal would extend the qualified advanced energy property (QAEP) credit. The QAEP credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind and other renewable energy component property, electric grids, carbon dioxide capture and sequestration property, plug-in electric vehicles and component parts, etc. QAEP credits were first enacted as part of the American Recovery and Reinvestment Act of 2009, and \$2.3 billion in QAEP credits were originally authorized. All of the credits were allocated in a competitive application process by Treasury in two separate allocation rounds.

The administration's FY 2017 proposal would authorize an additional \$2.5 billion of QAEP credits. Up to \$200 million of the credits may be allocated to the construction of infrastructure that contributes to networks of refueling stations that serve alternative fuel vehicles. Under the proposal, taxpayers would be allowed to apply for a credit with respect to either all or only **a part of** the qualified investment in the project. If a taxpayer applies for a credit with respect to only a portion of its qualified investment, the taxpayer's increased cost sharing and the reduced cost to the government would be taken into account in the allocation process.

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

Extend the tax credit for second generation biofuel production

Similar to last year, the administration's FY 2017 proposal would extend the tax credit for cellulosic biofuel producers. Section 40 provides a \$1.01 per gallon tax credit for the production of cellulosic biofuels until December 31, 2016.

The administration's FY 2017 proposal would extend the tax credit for blending cellulosic fuel at \$1.01 per gallon through December 31, 2022, and reduce the amount of the credit by 20.2 cents per gallon in each subsequent year. The credit would then expire after December 31, 2026.

Provide a tax credit for the production of advanced technology vehicles

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

The administration's FY 2017 proposal would replace the credit for plug-in electric drive motor vehicles with a credit for "advanced technology vehicles." An advanced technology vehicle is a vehicle meeting the following criteria:

- The vehicle operates primarily on an alternative to petroleum;
- As of January 1, 2015, there were few vehicles in operation in the United States using the same technology as such vehicle; and
- The technology used by the vehicle exceeds the footprint-based target miles-per-gallon gasoline equivalent (MPGe) by at least 25%.

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

Under the administration's FY 2017 proposal, the credit would be available to the manufacturer of the vehicle, but the manufacturer would have the option to transfer the credit to a dealer that sells the vehicle to the end-use purchaser of the vehicle. If the credit is transferred to an end-use business purchaser, the purchaser would not be required to reduce the basis of the depreciable property by the amount of the credit.

The credit would be allowed for vehicles placed in service after 2016 and before January 1, 2024, though the credit would step down by 25% each year starting in 2021.

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

The administration's FY 2017 proposal would provide a tax credit for certain medium- and heavy-duty weight vehicles that are powered by alternative fuels.

Section 30B provides credits for a taxpayer who places in service alternative motor vehicles. Currently, section 30B provides a credit for fuel-cell vehicles, and the credit is available for vehicles purchased before 2017. Section 30B also provides a credit for alternative-fuel motor vehicles; however, that credit expired in 2011.

The administration's FY 2107 proposal would allow a tax credit for dedicated alternative fuel vehicles weighing more than 14,000 pounds (i.e., trucks and buses). The administration would allow a credit of \$25,000 for vehicles weighing up to 26,000 pounds and a credit of \$40,000 for vehicles weighing more than 26,000 pounds.

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

The credit would be allowed for vehicles placed in service after 2016, and before 2023. For vehicles placed in service in calendar year 2022, the credit would be limited to 50% of the otherwise allowable amount.

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

The administration's FY 2017 proposal would modify and extend the section 45L credit for the construction of new energy efficient homes.

Under section 45L, the credit is \$1,000 per manufactured home for homes 30% more efficient in terms of heating and cooling than a comparable dwelling constructed in accordance with certain prescribed standards. The section 45L credit is \$2,000 per home for homes 50% more efficient than the standard. The credit applies to homes acquired before January 1, 2017.

For homes acquired after December 31, 2016, and before January 1, 2027, the proposal would provide a \$1,000 tax credit for the construction of a qualified ENERGY STAR certified new home acquired for use as a residence. A \$4,000 tax credit would be available for a qualified DOE Zero Energy Ready Home that is manufactured and acquired for use as a residence. Verification by a qualified third party would be required to certify that a new home meets ENERGY STAR or DOE Zero Energy Ready guidelines.

Incentives to promote regional growth

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

The NMTC is a credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE), held for a period of seven years. The allowable credit totals 39% of the amount paid to the CDE for the investment at its original issue, and it is apportioned over the seven-year period after the purchase (5% for each of the first three years, 6% for each of the remaining four years). The credit may be recaptured if the entity ceases to be a qualified CDE during this seven-year period, if the proceeds of the investment cease to be used as required, or if the equity investment is redeemed. Only a specific dollar amount of QEIs can be designated each year; the NMTC will expire on December 31, 2019.

The administration's FY 2017 proposal would make the NMTC permanent, with an allocation of \$5 billion for each year after 2019, and would permit NMTC amounts resulting from QEIs made after December 31, 2019, to offset alternative minimum tax (AMT) liability. The proposal would be effective after December 31, 2019.

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

Similar to last year's budget proposal, the administration proposes the following for FY 2017:

- Provide two ways in which the private activity bond (PAB) volume cap could be converted into LIHTCs:
 - (1) States may convert an annual maximum PAB volume cap into LIHTC allocations for the same year. The conversion ratio would be reset each calendar year to respond to changing interest rates.
 - (2) Taxpayer may qualify for the 30% present value LIHTC—generally allowed for projects at least 50% financed with tax exempt bonds—without actually getting such financing if there is an allocation of PAB volume cap in the required amount of financing.
- Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income
- Add preservation of publicly assisted affordable housing to allocation criteria
- Remove the qualified census tracts (QCT) population cap
- Implement requirement that LIHTC-supported housing protect victims of domestic abuse

Unlike the FY 2016 proposal, the administration did not propose to change formulas for the 70% or the 30% present value credit rates.

Incentives for investment in infrastructure

Provide America Fast Forward Bonds and expand eligible uses

The proposed America Fast Forward Bond (AFFB) program is similar to the administration's FY 2014 proposal for making permanent the Build America Bond (BAB) program. The proposed AFFB program would provide direct payments to state and local governmental issuers in an amount equal to 28% of the coupon interest, a federal subsidy level that is intended to be approximately revenue neutral relative to the estimated future federal tax expenditures for tax-exempt bonds. Unlike the BAB program, the AFFB program would be protected from sequestration.

In addition to containing all the eligible uses that the BAB program contained, the proposed AFFB program would provide additional eligible uses, including: financing for the types of projects and programs that can be financed with qualified private activity bonds, (subject to the applicable state bond volume caps for the qualified private activity bond category). Eligible uses would be further expanded to include financing for projects that can be financed with "Qualified Infrastructure Bonds" (described below).

The proposal would be effective for bonds issued on or after January 1, 2017.

Allow current refundings of state and local governmental bonds

A "current refunding" or "current refunding issue" typically occurs when a state or local government aims to reduce interest costs by issuing bonds to refinance another outstanding bond issue when the outstanding bonds are redeemed or retired within 90 days after issuance of the current refunding bonds.

In order to promote greater uniformity and increased certainty in an area in which statutory provisions vary, the administration's FY 2017 proposal would set forth a general Code provision to authorize current refunding of state or local bonds upon satisfaction of certain requirements related to the size and maturity of the bonds. The provision would generally apply to state and local bond programs that do not otherwise allow current refunding or expressly address the treatment of current refunding. It would not affect refunding of bonds when current refundings are already allowed.

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

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

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

Under the proposal, the bond volume cap requirement and the AMT preference for interest on specified private activity bonds would be not applicable to QPIBs.

The proposal would immediately upon enactment remove those existing categories of exempt facilities that overlap with QPIB from the qualified private activity bond area, subject to a transitional exception for qualified highway or surface freight transfer facilities.

The proposal would be effective for bonds issued starting January 1, 2017.

Modify qualified private activity bonds for public educational facilities

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

By eliminating the private corporation ownership requirement, the proposal would allow any private person either to own the public school facilities, or to operate those school facilities through lease, concession, or other operating arrangements. Accordingly, the requirement to transfer the school facilities to a public agency would be eliminated, as would the separate volume cap for qualified public educational facilities. As a result, these facilities would be included under the unified annual state bond volume cap for private activity bonds under section 146.

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

Modify treatment of banks investing in tax-exempt bonds

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

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

The administration proposes to permanently expand the \$10 million qualified small issuer limit to permit such issuers to issue up to \$30 million of tax-exempt bonds annually. Financial institutions would be allowed to deduct 80% of interest expenses allocable to qualifying bonds of these qualified small issuers, without being limited to 2% of the financial institution's assets. In addition, beginning with bonds issued in 2017, the proposal would permanently allow financial institutions to deduct 80% of interest expense allocable to any tax-exempt bond, regardless of whether the bond is a qualified tax-exempt obligation. This exception, however, would continue to be limited to 2% of the financial institution's assets. Finally, the same rules that are applicable to C corporation financial institutions would also be applied to financial institutions that are S corporations or qualified subchapter S subsidiaries, thus generally applying similar 20% disallowance of interest expense rules to both.

The proposal would apply to bonds issued in calendar years beginning on or after January 1, 2017.

KPMG observation

This proposal would expand the bonds subject to the more favorable interest disallowance rules in section 291, but still preserve differences in treatment of different bonds. This proposal would only apply to tax-exempt bonds issued in 2017 or later. Bonds issued before 2008 or from 2011 to 2016 would continue to be subject to the current rules for interest disallowance, even if held in 2017 or in later years. Additionally, this proposal would continue to maintain slightly different treatment, primarily the 2% limit, for

qualified tax-exempt obligations and other tax-exempt obligations.

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

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

Repeal tax-exempt bond financing of professional sports facilities

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

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

The proposal would be effective for bonds issued after December 31, 2016.

Modify tax-exempt bonds for Indian tribal governments

Section 7871(c) generally restricts the authority of Indian tribal governments to issue tax-exempt bonds by limiting them to the financing of “essential governmental function” activities that are “customarily” performed by state and local governments with general

taxing powers. The *American Recovery and Reinvestment Act of 2009* (ARRA) provided \$2 billion in bond authority for a new category of Indian tribal government tax-exempt bonds known as “Tribal Economic Development Bonds.” This authority, in section 7871(f), generally permits use of tax-exempt bond financing under standards that are comparable to those applied to state and local governments.

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

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

Other bond proposals

The administration’s FY 2017 budget also contains several bond proposals intended to provide incentives for investment in infrastructure, including private investment, and to repeal certain existing incentives. These would:

- 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
- Simplify arbitrage investment restrictions for tax-exempt bonds
- Simplify single-family housing mortgage bond targeting requirements

Eliminate fossil fuel tax preferences

Eliminate fossil fuel tax preferences

As in last year’s budget proposal, the administration’s FY 2017 budget proposal would repeal several preferences currently available to the oil and gas sector, as listed:

- Repeal the section 43 enhanced oil recovery credit
- Repeal the section 45I credit for qualified crude oil and natural gas production from a marginal well
- Repeal the section 263(c) expensing of intangible drilling costs
- Repeal the section 193 deduction for tertiary injectants
- Repeal the section 469(c)(3) exception to passive loss limitation for working interests in oil and natural gas properties
- Repeal percentage depletion for oil and natural gas wells

- Repeal the section 199 domestic manufacturing deduction for oil and natural gas and coal and other hard mineral fossil fuels
- Increase geological and geophysical amortization period for independent producers to seven years under section 167(h)
- Repeal expensing of mining exploration and development costs
- Repeal percentage depletion for hard mineral fossil fuels
- Repeal capital gains treatment for coal and lignite royalties
- Repeal fossil fuel qualified income for publicly traded partnerships

KPMG observation

Elsewhere in the FY 2017 budget, there is a proposal to limit the amount of capital gain deferred under the like-kind exchange rules to \$1 million per taxpayer, per tax year. This provision could make oil and gas unitizations and poolings, and mine aggregations taxable events.

Reform the treatment of financial and insurance industry products

Require that derivative contracts be marked to market with resulting gain or loss treated as ordinary

Under current law, the timing and character of gain and loss on derivative contracts depends on how the contracts are classified or traded. For example, gain or loss with respect to a forward contract is generally recognized when the contract is transferred or settled and is generally capital if the contract is with respect to property that is or would be a capital asset in the hands of the taxpayer. In contrast, certain exchange-traded futures contracts must be marked to market and the gain or loss is 60% long-term and 40% short-term capital gain or loss. Similarly, the tax treatment of certain options differs depending on whether they are entered into over-the-counter or traded on certain exchanges.

Similar to the administration's FY 2015 and 2016 proposals, the administration's FY 2017 proposal would generally require that a "derivative contract," as defined in the proposal, be marked to market annually (no later than the last business day of a taxpayer's tax year). Gain or loss would be recognized for tax purposes and would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law. The proposal would also eliminate or amend a number of other provisions of the Code that address specific taxpayers and transactions, including

section 475 (mark to market for securities dealers), section 1256 (mark to market and 60/40 capital treatment), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sale transactions), and section 1260 (constructive ownership transactions).

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

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

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

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

The proposal would not, however, apply mark-to-market treatment to a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer’s trade or business primarily to

manage risk of certain price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. The proposal provides that the identification requirement would be met if the transaction is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligation. The proposal would apply to derivative contracts entered into after December 31, 2016.

KPMG observation

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

Modify rules that apply to sales of life insurance contracts

The administration's FY 2017 proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000 to report the purchase price, the buyer's and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

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

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

The provision would apply to sales or assignments of interests in life insurance policies and payments of death benefits in tax years beginning after December 31, 2016.

KPMG observation

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

This provision was included in the administration’s 2012 through 2016 revenue proposals.

Modify proration rules for life insurance company general and separate accounts

The administration’s FY 2017 proposal would change the existing regime for prorating investment income between the "company's share" and the "policyholders' share" for purposes of the dividends-received deduction (DRD). Instead of keying off the policyholders’ and company’s shares of net investment income, under the proposal the policyholders’ share would equal the ratio of an account’s mean reserves to mean assets and the company’s share would equal one less the policyholders’ share.

The provision would be effective for tax years beginning after December 31, 2016.

KPMG observation

Separate account DRD provisions have been included in the administration’s FY 2012 through FY 2016 revenue proposals. The FY 2017 proposal is consistent with the proposal in the Camp tax reform bill. The proposal would in effect eliminate the separate account DRD for most life insurance companies that issue variable life insurance and variable annuity products.

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

The administration’s FY 2017 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, 2016, 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.

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

Current law generally allows businesses to carry back a net operating loss (NOL) up to two tax years preceding the tax year of loss (loss year) and to carry forward an NOL up to 20 tax years following the loss year. Life insurance companies, however, that have a loss from operations (LO)—a life insurance company's NOL equivalent—may carry back the LO up to three tax years preceding the loss year, and carry forward an LO up to 15 tax years following the loss year. The administration believes that there is not a compelling reason why losses incurred by life insurance companies should be assigned more favorable tax treatment under the Code than that granted other taxpayers.

The budget proposal would make the rules for carrying over the losses from operations of life insurance companies the same as the rules for net operating losses of other companies: a two-year carryback and a 20-year carryforward.

The change would be effective for tax years beginning after December 31, 2016.

Other business revenue changes and loophole closers

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

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

The administration's FY 2017 proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2016. Taxpayers that use LIFO would be required to change their method of inventory accounting, and include in income, prior years' LIFO reserves (the amount deferred under the LIFO method). The resulting section 481(a) adjustment (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 2017 proposal would repeal the use of the LCM and subnormal goods methods for the tax years beginning after December 31, 2016. 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

Current law provides that no gain or loss is recognized when business or investment property is exchanged for "like-kind" business or investment property. Exchanges of art and collectibles for investment are currently eligible for deferral of gain under section 1031.

The Green Book indicates that difficulty of valuation is not the hurdle it once was and no longer justifies broad section 1031 deferral. The Green Book also indicates that, 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.

The FY 2017 proposal differs from previous budget proposals that would have limited the amount of deferral of capital gains under section 1031 only with respect to real estate. This year's proposal would limit the amount of capital gain deferred to \$1 million (indexed for inflation) per taxpayer, per tax year. As in previous proposals, art and collectibles would no longer be eligible for like-kind exchanges. Treasury would be granted regulatory authority necessary to implement the provision, including rules for aggregating multiple properties exchanged by related parties.

The provision would be effective for like-kind exchanges completed after December 31, 2016.

Modify depreciation rules for purchases of general aviation passenger aircraft

Similar to prior budget proposals, the depreciation recovery period for "general aviation passenger aircraft" would be extended from five (5) years to seven (7) years. These aircraft are defined as airplanes not used in commercial or contract carrying of passengers or freight

that are primarily used in carrying passengers (e.g., many “corporate jets”). Aircraft primarily used in emergency or emergency relief operations would be excluded from the definition. The change would apply to property placed in service after December 31, 2016.

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.

As was the case for the previous fiscal year’s budget proposal, the FY 2017 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 allowed 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. The adjustment would be required even if the partnership as a whole did not have a substantial built-in loss.

The proposal 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 2017 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) is allowed only to the extent of the partner’s adjusted basis in the partnership interest at the end of the year.

A Joint Committee on Taxation (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.

Deny deduction for punitive damages

The administration's FY 2017 proposal would prohibit any deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages were covered by insurance, damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report payments to the insured person and to the IRS.

The provision would apply to damages paid or incurred after December 31, 2016.

Conform corporate ownership standards

The administration's FY 2017 proposal would amend the "control test" under section 368 to adopt the "affiliation test" under section 1504. Thus, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, "plain vanilla" preferred stock).

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

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

The proposal would be effective for transactions occurring after December 31, 2016.

KPMG observation

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

Tax corporate distributions as dividends

The administration’s FY 2017 proposal would make several changes to the tax treatment of certain distributions of property by a corporation to its shareholder which, under current law, may not give rise to dividend income. The proposal explains that transactions of this type reduce a corporation’s earnings and profits but do not result in a reduction in a corporation’s dividend paying capacity, and are therefore inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation’s dividend-paying capacity. The FY 2017 proposal generally targets the same four transactions targeted in the FY 2016 proposal.

Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions: Generally, a corporation is required to recognize any gain realized on the distribution of any appreciated property to a shareholder, but does not recognize any loss realized on the distribution of property with respect to its stock. Although the corporation does not recognize a loss, with respect to a distribution of property with basis in excess of fair market value, its earnings and profits are decreased by the adjusted basis (for earnings and profits purposes) of loss property so distributed (but not below zero). Additionally, if an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder’s basis in any remaining stock of the corporation is increased by the shareholder’s basis in the redeemed stock.

Similar to the administration's FY 2015 and FY 2016 proposals, the FY 2017 proposal would amend section 312(a)(3) to provide that earnings and profits are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective on the date of enactment.

Prevent use of leveraged distributions from related corporations to avoid dividend treatment: Similar to the administration's FY 2016 proposal, the FY 2017 proposal would treat a leveraged distribution from a corporation to its shareholders that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation. This proposal revises a previous proposal to disregard a shareholder's basis in the stock of a distributing corporation for purposes of recovering such basis under section 301(c)(2).

This proposal would be effective for transactions occurring after December 31, 2016.

KPMG observation

The title for this section in the FY 2016 proposal included the phrase "related foreign corporations", while the FY 2017 proposal has omitted the word "foreign." Other than this change and the change in the effective date, the FY 2016 proposal language and the FY 2017 proposal language are identical.

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

The administration's FY 2017 proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entity) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would also grant the Secretary authority to prescribe regulations to treat purchases of interest in shareholder entities other

than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2016.

KPMG observation

The FY 2017 proposal is the same as the FY 2016 proposal. Note that this proposal not only creates a potentially taxable dividend, but also a potential zero tax basis in the hook stock received by the subsidiary.

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

Similar to the administration’s FY 2011 through FY 2016 proposals, the administration’s FY 2017 proposal would repeal the “boot within gain” limitation in the case of any reorganization if the exchange has the effect of the distribution of a dividend under section 356(a)(2). In addition, the FY 2017 proposal would align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2016.

KPMG observation

The FY 2017 proposal is the same as the FY 2016 proposal. The FY 2017 proposal refers to the rules under section 316 for purposes of determining the available pool of earnings and profits, while the prior FY 2015 proposal referred to “all of the available earnings and profits of the corporation.” It appears that this change may have been intended to clarify that the deemed dividend should follow normal dividend rules and not provide an earnings and profits priority to boot dividends.

Repeal Federal Insurance Contributions Act (FICA) tip credit

The administration’s FY 2017 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, 2016.

Repeal the excise tax credit for distilled spirits with flavor and wine additives

Similar to last year's budget proposal, the administration's FY 2017 proposal would repeal the credit for distilled spirits with flavor and wine additives and tax all distilled spirit beverages at the \$13.50 per proof-gallon rate. Current law allows a credit against the \$13.50 per proof-gallon excise tax on distilled spirits for flavor and wine additives.

The proposal would be effective for all spirits produced in or imported into the United States after December 31, 2016.

KPMG observation

The administration reasons that repeal of the credit would raise revenue and simplify tax collections. It states the credit should be repealed because it: (1) introduces differences in the prices of similar goods and thereby distorts decisions by producers and consumers; (2) creates tax advantages for foreign producers and production compared to domestic production because some countries allow greater use of additives than the United States; and (3) is complicated for taxpayers to calculate the credit and for the Alcohol and Tobacco Tax and Trade Bureau to enforce compliance with the provision as it requires information about specific components of the beverage rather than alcohol content alone.

MIDDLE CLASS AND PRO-WORK REFORMS

Reform child care tax incentives

Under current law, a nonrefundable tax credit is allowed to certain working taxpayers for up to 35% of their child and dependent care expenses, limited to \$3,000 of eligible expenses for one child or dependent, and \$6,000 for two or more children or dependents. The 35% rate decreases by one percentage point for every \$2,000 (or part thereof) of AGI over \$15,000 until the percentage reaches 20% for AGI above \$43,000. The phase down and expense limits are not indexed for inflation.

In addition, some individuals receive dependent care assistance from their employers, either directly or through being permitted to set aside funds for child and dependent care in a flexible spending account (FSA). Up to \$5,000 in assistance or employee

contributions is excludible from an employee's wages.

The administration's FY 2017 proposal would repeal dependent care flexible spending accounts. The child and dependent care credit would be modified by significantly increasing from \$15,000 to \$120,000 the income level at which the child and dependent care credit phases down, so that the rate would reach 20% at income above \$148,000. Taxpayers with children under age five could claim a credit of up to 50% of expenses up to \$6,000 (or \$12,000 for two children under age five). The rate for this young child credit would phase down at a rate of one percentage point for every \$2,000 (or part thereof) of AGI over \$120,000 until the rate reaches 20% for taxpayers with AGI above \$178,000. The expense limits and phase down thresholds would be indexed for inflation after 2017.

The proposal would be effective for tax years beginning after December 31, 2016.

Simplify and better target tax benefits for education

Last year, the administration's FY 2016 proposal included a proposal to make permanent the American opportunity tax credit (AOTC). The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), signed into law on December 18, 2015, included a provision to this effect. The administration's FY 2017 proposal would make additional changes to the tax benefits for education in several areas.

Expand and modify the AOTC: The administration's FY 2017 proposal would expand and modify the AOTC such that it would replace the lifetime learning credit (LLC) and the deduction for student loan interest. The LLC is a credit of 20% of up to \$10,000 in qualified tuition and related expenses that may be claimed for an unlimited number of years.

The AOTC is currently available for the first four years of post-secondary education. Pursuant to the administration's FY 2017 proposal, the AOTC would be available for the first five years of post-secondary education and for five tax years. Students studying less than half-time would be eligible to claim a part-time AOTC equal to 50% of the first \$2,000 of eligible expenses plus 12.5% of the next \$2,000 of eligible expenses. Students studying at least half-time would continue to be eligible to claim an AOTC of 100% of the first \$2,000 of eligible expenses and 25% of the next \$2,000 of eligible expenses, as under current law. However, students who can be claimed as a dependent on someone else's tax return would no longer be able to claim the non-refundable portion of the AOTC on their own returns.

Make Pell Grants excludible from income: Pell grants are postsecondary education federal grants sponsored by the U.S. Department of Education. The administration's FY 2017 proposal would make all Pell grants excludable from gross income without regard to whether they are used for qualified expenses or for other expenses such as living expenses. This would

provide that the tax benefits a student may receive from the AOTC would not be reduced by the Pell grant, and would also remove the complexity involved in trying to maximize the tax benefits from the AOTC in relation to the Pell grant.

Modify reporting of scholarships on Form 1098-T: The reporting of tuition expenses and scholarship income on Form 1098-T would be modified, by requiring any entity issuing a scholarship or grant in excess of \$500 (indexed for inflation after 2017) that is not processed or administered by an institution of higher learning to report the amount on Form 1098-T.

Reforms to student loans: The administration's FY 2017 proposal would make four changes to the rules governing student loans.

- First, the student loan interest deduction for new students would be repealed.
- Second, the administration's FY 2017 proposal would exclude the forgiven or discharged portion of a federal student loan from gross income in cases where the loan was forgiven or discharged as part of a program administered by the U.S. Department of Education.
- Third, the administration's FY 2017 proposal would conform various tax treatments of loan amounts repaid by the Indian Health Service (IHS) Scholarship Program, the IHS Loan Forgiveness Program, loan amounts paid by the National Health Service Corps (NHSC) and certain state programs, as well as IHS Health Professions Scholarships, NHSC scholarships, and Armed Forces Health Professions (AFHP) scholarships.
- Fourth, the administration's FY 2017 proposal would allow the Secretary of the Treasury to disclose identifying information to the Department of Education for the purpose of contacting late-stage delinquent borrowers to inform them about their options for avoiding default on their student loans. This proposal would also allow the Department of Education to re-disclose this information to certain lenders, guarantee agencies and educational institutions.

The proposals in relation to the tax benefits for education would generally be effective for tax years beginning after December 31, 2016, except that the provisions concerning student loan forgiveness would be effective for discharges of loans after December 31, 2016, and the provisions expanding disclosure in relation to delinquent loans would be effective upon enactment.

Expand the earned income tax credit (EITC) for workers without qualifying children

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

The administration's FY 2017 proposal would double the maximum EITC for workers without qualifying children by doubling the phase-in and phase-out rates for such individuals from 7.65% to 15.3%. The age range of individuals eligible to claim the EITC for workers without qualifying children would be expanded from the current 25-64 years to 21-66 years. For married taxpayers filing jointly, the credit could be claimed if either spouse falls within the age range.

This proposal would be effective for tax years beginning after December 31, 2016.

Simplify the rules for claiming the EITC for workers without qualifying children

The administration's FY 2017 proposal would simplify the rules for claiming the EITC for workers without qualifying children. Under current law, certain taxpayers with low wages who do not have any qualifying children may still be eligible to claim the EITC in a smaller amount than for workers with qualifying children. However, such taxpayers would be allowed no EITC if they reside with a qualifying child whom they do not claim as a qualifying child (because, for example, the child is claimed by another individual in the household).

The administration's FY 2017 proposal would allow otherwise eligible taxpayers to claim the EITC when such taxpayers reside with children whom they do not claim.

This proposal would be effective for tax years after December 31, 2016.

Provide for a second earner tax credit

Married couples, both of whom earn income, can be subject to higher rates of tax whether they file joint or separate returns, as compared to the rates that would apply to them if they filed as two single individuals. This "marriage penalty" can have the effect of discouraging the second earner from working.

The administration's FY 2017 proposal would provide two-earner married couples who file jointly a non-refundable tax credit equal to a percentage of the lower earner's earned income up to \$10,000. For purposes of this credit, earned income includes wages and net earnings from self-employment. The credit rate would be 5% but would be subject to phase-out of 0.5% for every \$10,000 of AGI over \$120,000. Thus, the maximum credit would be \$500 and it would be fully phased out at AGI over \$210,000. The earned income amount of \$10,000 and the phase-out threshold of \$120,000 would be indexed for inflation after 2017.

The proposal would be effective for tax years after December 31, 2016.

Extend exclusion from income for cancellation of certain home mortgage debt

Gross income generally includes income realized from the discharge of indebtedness. Under current law, an exception to this general rule exists for qualified principal residence interest (QPRI), which is acquisition indebtedness with respect to a taxpayer's principal residence, limited to \$2 million (\$1 million for married taxpayers filing separately). Pursuant to this exception, taxpayers are allowed to exclude income from the discharge of QPRI. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for QPRI relief, which currently applies to debt forgiven before January 1, 2017, and to amounts that are discharged pursuant to an agreement entered into before that date.

The administration's FY 2017 proposal would extend the exclusion from income for QPRI to amounts that are discharged by December 31, 2017, and to amounts that are discharged pursuant to an agreement entered into before that date.

REFORMS TO RETIREMENT AND HEALTH BENEFIT PLANS

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 2017 budget 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, 2017.

Expand penalty-free withdrawals for long-term unemployed

The administration’s FY 2017 proposal would expand the exception from the 10% additional tax for early withdrawal from a qualified retirement plan to include distributions to certain long-term unemployed individuals from an IRA, 401(k), or other tax-qualified defined contribution plan.

The provision would apply to eligible distributions occurring after December 31, 2016.

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

The administration’s FY 2017 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. Employers would receive nondiscrimination testing relief, including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements after expanding the eligibility group.

This provision would apply to plan years beginning after December 31, 2016.

Facilitate annuity portability

The administration’s FY 2017 budget proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan. The distribution would not be subject to the 10% additional tax.

The provision would be effective for plan years beginning after December 31, 2016.

Simplify minimum required distribution (MRD) rules

The administration’s FY 2017 budget proposal would exempt an individual from the MRD requirements if the aggregate value of the individual’s IRA and tax-favored retirement

plan accumulations does not exceed \$100,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase-in ratably for individuals with aggregate retirement benefits between \$100,000 and \$110,000.

The administration's FY 2017 proposal would harmonize the application of the MRD requirements for holders of designated Roth accounts and Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½ years. Individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½ years.

The provisions would be effective for individuals attaining age 70½ after December 31, 2016, and for taxpayers who die on or after December 31, 2016 before attaining age 70½ years.

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

The administration's FY 2017 proposal would expand the option available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited-plan or IRA assets by allowing 60-day rollovers of such assets.

The provision would be effective for distributions made after December 31, 2016.

Permit unaffiliated employers to maintain a single multiple-employer defined contribution plan

The administration's FY 2017 budget proposal would amend ERISA to permit unaffiliated employers to adopt a defined contribution multiple-employer plan (MEP) that would be treated as a single plan for ERISA purposes, even though the employer may not have a commonality of interests.

Unaffiliated employers eligible to participant in such a MEP would be employers that had not maintained a qualified plan within the previous three years. The provider would be required to be a regulated financial institution and agree to be a named fiduciary of the plan and the plan administrator. The provider would be required to register with the Secretary of Labor before offering the plan to employers. Each participating employer would retain fiduciary responsibility for selecting and monitoring the provider. Employers would be responsible for transmitting employee contributions to the trustee within a specified time frame.

The provision would be effective for years beginning after December 31, 2016.

KPMG observation

Similar to the auto-enrolled employer IRAs in the administration's FY 2017 proposal, this provision is meant to encourage greater participation in retirement programs by smaller employers.

Improve the excise tax on high cost employer-sponsored health coverage

The administration's FY 2017 budget proposal would modify section 4980I—the excise tax on high cost employer-sponsored health coverage enacted in 2010 as part of the Patient Protection and Affordable Care Act. The administration's FY 2017 budget proposal would raise the threshold at which health plans are subject to the tax in states with higher health-care costs. Specifically, the proposal would modify the threshold above which the tax applies to be equal to the greater of the current law threshold (\$10,200 for individual coverage and \$27,500 for family coverage, in 2018 dollars) or the average premium for a gold-level health plan in the employees' state of residency.

In addition, the proposal would provide that the cost of coverage under a health flexible spending arrangement (FSA) for similarly situated participating employees is equal to the sum of: (1) the average salary reduction amount elected by those employees for the year; and (2) the average employer contribution for such employees for the year. Furthermore, the proposal would authorize the Secretary of the Treasury to issue guidance identifying similarly situated employees.

Finally, the proposal would require the Government Accountability Office to conduct a study of the potential effects of the excise tax on firms with unusually sick employees, in consultation with Treasury and others. The provision would be effective for tax years beginning after December 31, 2016. However, as under current law, no employer-sponsored health plans would be subject to the tax until 2020.

KPMG observation

This is a new budget proposal designed to lessen the effects of the excise tax on high cost employer-sponsored health coverage (often referred to as the "Cadillac tax") in geographic areas where health care costs are higher than the national average. Furthermore, the proposal appears to be intended to make it easier for employers offering FSAs to calculate the excise tax owed by providing a formula for measuring the cost of coverage under an FSA.

The effective date of the tax was postponed until 2020 through legislation enacted in December 2015, and legislative proposals have been introduced by members of Congress to repeal the excise tax entirely.

REFORMS TO CAPITAL GAINS TAXATION, UPPER-INCOME TAX BENEFITS,

AND THE TAXATION OF FINANCIAL INSTITUTIONS

Reduce the value of certain tax expenditures

The administration's FY 2017 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 39.6% 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 \$3,960—a tax increase of \$11.60 per \$100 of itemized deductions compared with current law.

This provision would be effective for tax years beginning after December 31, 2016.

Reform the taxation of capital income

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 15% or 20% (for taxpayers subject to the highest rate of income tax) with an additional 3.8% net investment income tax which may also be applicable on the gain. Currently, when an individual transfers assets at death, the recipient generally receives the assets with a basis equal to the fair market value of the asset on the date of death. 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 increase the tax rate on long-term capital gains (and qualified dividends) to 24.2%, which in conjunction with the 3.8% net investment income tax would tax long-term capital gains at 28%. The administration's proposal would also treat the transfer of appreciated property (during life or at death) as a sale of the property 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 when 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 is effective for long-term capital gains realized and qualified dividends received in tax years after December 31, 2016, and for gifts made and for decedents dying after December 31, 2016.

Implement the Buffett rule by imposing a new "fair share tax"

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

The wage base for much of the payroll tax is capped at \$118,500 in 2016, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below \$118,500 (although half this amount is the liability of the employer).

The administration's FY 2017 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 2017.

The proposal would be effective for tax years beginning after December 31, 2016.

Impose a financial fee

The administration proposes to impose a fee on financial entities. The stated purpose of this fee is to reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.*

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

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

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

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

According to the administration’s estimates, the fee would raise \$111 billion over 10 years and would apply to roughly 100 firms with assets over \$50 billion.

The fee would be effective after December 31, 2016.

KPMG observation

Similar to the administration's FY 2016 proposal, the proposed fee would apply not just to banks, but could also apply to insurance companies, exchanges, asset managers, broker-dealers, specialty finance companies, and financial captives. This would greatly expand the base of entities subject to the tax. It is unclear how some of these entities (e.g., asset manager and specialty finance companies) would be defined.

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

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

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

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

Similar to the administration's FY 2016 proposal, the administration's FY 2017 proposal would require holders of debt instruments with market discount to include market discount currently in taxable ordinary income as it accrues. The proposal would require accrual of market discount on a constant yield basis. The proposal would also limit the accrual of market discount to the greater of: (1) the bond's yield to maturity plus 5%; or (2) the

applicable federal rate for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2016.

KPMG observation

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

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

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

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

For portfolio stock with respect to which the taxpayer has a long-term holding period, the administration's FY 2017 proposal would require taxpayers to determine the basis of stock sold using an average basis method. The average basis method would be applied to all identical shares of portfolio stock with a long-term holding period held by the taxpayer, including stock held through a different broker or in a separate account, but would not apply to shares held in a nontaxable account, such as an individual retirement account. The statute would provide authority to the Secretary to draft regulations applying the average basis method to stock other than portfolio stock. Special rules could also be required to coordinate the average basis method with the rules applicable to stock in passive foreign investment company.

The proposal would apply to portfolio stock acquired after December 31, 2016.

KPMG observation

The proposal would only apply to portfolio stock with respect to which a taxpayer has a long-term holding period, and only to portfolio stock acquired after December 31, 2016. However, it does not define portfolio stock. This term is defined in section 246A, but it is not clear that the proposal is relying upon this definition.

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

Tax carried (profits) interests as ordinary income

The administration's FY 2017 proposal includes a measure to tax carried interests in investment partnerships as ordinary income, effective for tax years ending after December 31, 2016. 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 former Ways and Means Chairman Camp's 2014 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.

KPMG observation

The proposal does not adopt a change made in the Carried Interest Fairness Act of 2015 (H.R. 2889 and S. 1686) which, in defining the scope of an “investment partnership,” would have required only that “less than 75 percent of the capital in the partnership is attributable to qualified capital interests which constitute property held in connection with the trade or business of the owner of such interest.” By retaining the “over half” threshold from prior proposals, slightly fewer entities would qualify as “investment partnerships,” so that interests in these excluded entities would not be subject to the carried interest proposal.

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

Under the administration’s FY 2017 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries, including any beneficiary who, as of the date of the account holder’s death, is: (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant or IRA owner; or (4) a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner, except that in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

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

The proposal generally would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2016. However, the requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary’s death would apply to participants or IRA owners who die before January 1, 2016, if the beneficiary dies after December 31, 2016. The proposal would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

Limit the total accrual of tax-favored retirement benefits

Under the administration's FY 2017 proposal, a taxpayer who has accumulated amounts within the "tax-favored retirement system" (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of \$210,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 years is approximately \$3.4 million.

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

The Green Book also explains that if a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law.

The provision would be effective with respect to contributions and accruals for tax years beginning after December 31, 2016.

Rationalize Net Investment Income Tax (NIIT) and Self-Employment Contributions Act (SECA) Taxes

The NIIT and the SECA taxes impose a 3.8% tax on certain income and gain of individuals over a threshold amount. The threshold amounts are \$200,000 (for single and head of household returns) and \$250,000 (for joint returns). Individuals with incomes over these thresholds may currently be excluded from either of these taxes, however. For example, limited partners and S corporation shareholders who materially participate in their businesses may avoid both the SECA taxes and the NIIT on certain income and gains.

The proposal has two components and would be effective for tax years beginning after December 31, 2016. The first component is to amend the definition of net investment income to include income and gain from any trade or business of an individual that is not otherwise subject to SECA taxes. In other words, if an individual has trade or business income that is not subject to SECA because of certain exclusions from SECA, that income would be treated as net investment income. The proposal would also cause gain on the sales of trade or business property to be included in the definition of net investment income. As under current law, the tax on net investment income would apply only to individuals with incomes over the thresholds. In addition, all revenue from the NIIT would be directed to the Medicare Hospital Insurance Trust Fund, just as is the revenue from the current 3.8% tax under FICA and SECA.

The second component is to treat individual owners of professional service businesses taxed as either S corporations or partnerships as subject to SECA taxes in the same way. Professional service businesses would be defined as partnerships and S corporations if substantially all of the activities 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.

Owners who materially participate in the trade or business would be subject to the SECA taxes on their distributive shares of S corporation or partnership income. The current exemptions from SECA (for rents, dividends, capital gains, and certain retired partner income) would continue to apply. Owners who do not materially participate in the trade or business would be subject to SECA only on the "reasonable compensation" for their services, including guaranteed payments for services. Finally, distributions of compensation to owners of S corporations and partnerships would no longer be treated as wages subject to FICA but would be included in earnings subject to SECA taxes.

Limit Roth conversions to pre-tax dollars

The administration's FY 2017 proposal would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the

extent a distribution of those amounts would be includable in income if they were not rolled over. After-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans.

The proposal would apply to distributions occurring after December 31, 2016.

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

The administration's FY 2017 proposal would repeal the deduction for dividends paid with respect to employer stock held by an ESOP that is sponsored by a publicly traded corporation. Rules allowing for immediate payment of an applicable dividend would continue, as would rules permitting the use of an applicable dividend to repay a loan used by the ESOP to purchase the stock of the publicly traded corporation. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

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

Repeal exclusion of net unrealized appreciation in employer securities

The administration's FY 2017 proposal would repeal the exclusion of net unrealized appreciation in employer stock in the year of a distribution for participants in tax-qualified retirement plans who have not yet attained age 50 as of December 31, 2016. Participants who have attained age 50 on or before December 31, 2016 would not be affected by the provision.

The provisions would apply to distributions made after December 31, 2016.

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 2017 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, 2016.

MODIFY ESTATE AND GIFT TAX PROVISIONS

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

The administration's FY 2017 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 2016 budget and would be effective for those decedents dying, and for transfers made, after December 31, 2016.

Require consistency in value for transfer and income tax purposes

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act) implemented a portion of the administration's FY 2016 proposal by amending section 1014 to provide generally that the recipient's initial basis in property as determined under section 1014 cannot exceed the final value of that property for estate tax purposes if that property's inclusion in the decedent's gross estate increases the estate's liability for federal estate tax. The administration's FY 2017 proposal would expand the property subject to the consistency requirement imposed under section 1014(f) to: (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability; and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

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

KPMG observation

When Congress needed funding for the transportation bill this summer, it used a narrower version of the provision proposed in the administration's FY 2016 proposal as a revenue source to partially pay for the Act. This proposal seeks to expand the revised law to require consistency of basis even if those assets do not increase the estate tax. Many estates file only for portability purposes or have assets that qualify for a marital deduction and as such will owe no estate tax regardless of the reported values. This provision would expand the number of estates subject to the consistency requirement.

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

The administration's FY 2017 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 2016 budget. The proposal also continues 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 would also 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 also proposes 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). A substantially similar provision was included in the administration's FY 2016 budget.

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

KPMG observation

The FY 2017 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 2017 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 2016 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 when estate consists largely of interest in closely held business

The administration's FY 2017 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 2016 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 proposes 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. This proposal is substantially similar to the provision included in the administration's FY 2016 budget.

The proposal would apply to trusts created and transfers made after date of introduction.

Simplify gift tax exclusion for annual gifts

The administration proposes to eliminate the gift tax annual exclusion's present interest requirement with respect to certain gifts. Further, the proposal would impose an annual gift tax annual exclusion limit per donor of \$50,000 (indexed for inflation after 2017) 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. These proposals are substantially similar to the proposals included in the administration's FY 2016 budget.

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

Expand applicability of definition of executor

The administration proposes 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. This proposal is substantially similar to the provision included in the administration's FY 2016 budget.

The proposal would apply upon enactment, regardless of decedent's date of death.

OTHER REVENUE RAISERS

Impose an oil fee

Under this new provision, a fee equal to \$10.25 per barrel (adjusted for inflation from 2016) would be phased in evenly over a five-year period (i.e., \$2.05/year) beginning in October 1,

2016. Exported petroleum products would not be subject to the fee, and home heating oil would be temporarily exempted.

KPMG observation

- It is unclear when and where the tax would be imposed.
- It is unclear who would be liable for payment of the tax.
- It is unclear when the tax would be due.
- It is unclear whether the exported petroleum products exemption would include crude oil.
- It is unclear how long the home heating oil exemption would be available.

Increase and modify Oil Spill Liability Trust Fund financing

Similar to last year, the administration's FY 2017 proposal would increase by \$0.02 per barrel the taxes imposed on crude oil and imported petroleum products under the Oil Spill Liability Trust Fund financing rate, to \$0.10 per barrel for periods beginning after December 31, 2016.

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

The administration's proposal would extend the tax to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock. For periods after December 31, 2016, the proposal would also prohibit a drawback of the tax under the Customs drawback statute (19 U.S.C. 1313) when products subject to the tax are exported.

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

Reinstate Superfund taxes

For periods beginning after December 31, 2016, the administration's FY 2017 proposal would reinstate and extend through December 31, 2026, the following Superfund excise taxes that were imposed before 1996:

- An excise tax on domestic crude oil and on imported petroleum products at a rate of \$0.097 per barrel. The tax would also be extended to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock.

- An excise tax on listed hazardous chemicals at a rate that varied from \$0.22 to \$4.87 per ton (chemical excise tax).
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

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

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

Increase tobacco taxes and index for inflation

Similar to last year's proposal, for articles removed after December 31, 2016, the administration's FY 2017 proposal would increase the taxes imposed on tobacco products. The proposal would increase the rates of federal excise taxes imposed tobacco products that are manufactured in or imported into the United States as follows:

- Cigarettes and small cigars, which are currently taxed at \$50.33 per thousand would be taxed at \$97.50 per thousand
- Large cigars, which are currently taxed at 52.75% of the sales price (with a maximum of \$402.60 per 1,000), would be taxed at rates approximately equivalent to the increased cigarette rate (using five per-unit rates that vary according to the cigar's weight)
- Chewing tobacco would increase from \$0.5033 to \$44.23 per pound
- Snuff would increase from \$1.51 to \$44.23 per pound
- Pipe tobacco would increase from \$2.8311 to \$44.23 per pound
- Roll your own tobacco would increase from \$24.78 to \$44.23 per pound

These rates would be indexed for inflation annually beginning in 2018.

The proposal also includes a one-time floor stocks tax that generally applies to tobacco products (other than large cigars), cigarette papers, and tubes that are held for sale on January 1, 2017, and clarifies the definition of roll-your-own tobacco.

KPMG observation

The proposed tax rate increase would be significant. For example, the tax on cigarettes would be increased from just over \$1.00 per pack to approximately \$1.95 per pack.

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. This 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 2017 proposal would reinstate the 0.2% surtax and make it permanent.

The provision would be effective for wages paid after December 31, 2016.

Expand Federal Unemployment Tax Act (FUTA) base and reform FUTA credit reduction rules

The administration's FY 2017 proposal would raise the FUTA wage base in 2018 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 0.167%. States with wage bases below \$40,000 would need to conform to the new FUTA base in order to receive the full FUTA credit. 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 2018.

The provision would be effective upon the date of enactment.

REDUCE THE TAX GAP AND MAKE REFORMS

Expand information reporting

KPMG observation

Among other things, the administration proposes assorted amendments or additions to the various I.R.C. information reporting requirements. Purposes of the proposals include revenue enhancement, targeting tax avoidance, and fighting identity theft and other fraudulent activities. It is unknown what the overall effect of these proposals will be on any particular

taxpayer or entity, but these proposals, if passed, would increase—possibly significantly—the costs and burdens associated with the information reporting requirements applicable to a number of domestic and multinational industries and taxpayers. Most of these proposals are identical to those included in past years' proposals.

Improve information reporting for certain businesses and contractors

Require Form W-9 from contractors: In general, a reportable payment made in the course of a trade or business to a service provider is not subject to withholding if the service provider furnishes a taxpayer identification number (TIN) to the payor prior to the time payment is made. The administration's FY 2017 proposal would require service providers to furnish their TINs on Form W-9, thereby certifying the correctness of their TINs. Service recipients would be required to verify the accuracy of the TIN with the IRS (through the IRS TIN matching program). Service providers that fail to furnish a certified TIN that matches IRS records would be subject to backup withholding. Alternatively, service providers could request (and require) the service recipient to withhold a flat-rate percentage (selected by the service provider) of the gross payment made.

The provision would be effective for payments made to contractors after December 31, 2016. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Require information reporting for private separate accounts of life insurance companies: The administration's FY 2017 proposal would require life insurance companies to report to the IRS—for each contract with cash value that is partially or wholly invested in a private separate account for any portion of the tax year and represents at least 10% of the value of the account—(1) the policyholder's taxpayer identification number; (2) the policy number; (3) the amount of accumulated untaxed income; (4) the total contract account value; and (5) the portion of that value that was invested in one or more private separate accounts.

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

The provision would be effective for private separate accounts maintained on or after December 31, 2016. This provision was included in the administration's FY 2012 through FY 2016 revenue proposals.

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

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

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

The FY 2017 proposal would amend section 6103(k) to permit the IRS to disclose to any person required to provide the TIN of another person to the Secretary whether the information matches the records maintained by the Secretary.

The proposal would be effective on the date of enactment. This proposal was included in previous budget proposals.

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

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

The administration's FY 2017 proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal. Finally, the proposal would require financial institutions that are required by FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

The proposal would be effective for returns required to be filed after December 31, 2017.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. businesses with respect to the proposed expansion of reporting. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

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

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

The administration's FY 2017 proposal would require employers to report the amounts an employer contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2.

The proposal (included in previous budget proposals) would be effective for information

returns due for calendar years beginning after December 31, 2016.

Improve compliance by businesses

Increase certainty with respect to worker classification

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

The administration’s FY 2017 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 proposal would also clarify rules with respect to Tax Court jurisdiction in relevant proceedings and make technical and conforming changes to those rules.

The provision (included in previous budget proposals) 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 employee status 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 and 2016 revenue proposals.

Increase information sharing to administer excise taxes

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

The FY 2017 proposal would be effective on date of enactment. This provision was included in the administration's FY 2016 revenue proposal.

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

Knowledge of the beneficial owners of an entity can help law enforcement officials identify and investigate criminals engaged in financial crimes related to money laundering and terrorism financing.

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

The FY 2017 proposal would make various changes to the law in this area. The proposal would require that all entities formed in a U.S. state or a U.S. territory (U.S. entity) obtain an EIN, providing a universal identifier for these entities and ensure that responsible party information is provided for every U.S. entity. The proposal also would allow the Secretary to share responsible party information with law enforcement without a court order to combat money laundering, terrorist financing, and other financial crimes.

The proposal would impose various penalties: a \$10,000 penalty for failure to obtain an identifying number unless the entity had reasonable cause for the failure, and a \$100 penalty for failure to update information provided to the Secretary when applying for an identifying number, which could also be waived for reasonable cause. The latter penalty

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

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

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

This provision was included in the administration's FY 2016 revenue proposal.

Strengthen tax administration

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. According to the Green Book, 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 2017 proposal would 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 10 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 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 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 proposals would be effective for contributions made after the date of enactment.

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

The administration's FY 2017 proposal would add a new provision to the Code designed to impose liability on shareholders who engage in "Intermediary Transaction Tax Shelters." Previously, the IRS and Treasury identified Intermediary Transaction Tax Shelters as listed transactions that require disclosure on a tax return to avoid certain penalties. Intermediary Transaction Tax Shelters typically involve: (1) a sale of a controlling interest (at least 50%) in the stock of a C corporation; (2) that is undertaken as part of a plan; (3) to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation's stock. The C corporation is ultimately left with insufficient assets from which to pay the tax owned from the asset sale. This would occur, for example, when sales proceeds from the asset sale are used to repay acquisition financing.

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

The administration's FY 2017 proposal would create a new provision that would impose liability on shareholders who enter into Intermediary Transaction Tax Shelters. Specifically, the proposal would apply to shareholders who, pursuant to a plan, directly or indirectly, dispose of a controlling interest (at least 50%) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the C corporation. Such secondary liability would be imposed only after the C corporation is assessed income taxes and penalties and fails to pay such amounts within a specified time period. This deficiency would be governed by the general notice and

demand rules of the Code but with an additional year added to the statute of limitations for assessment. Treasury would be granted authority to prescribe regulations to carry out the proposal.

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

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

The provision would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2013. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Implement a program integrity statutory cap adjustment for tax administration

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

The administration's FY 2017 proposal would make an adjustment to the discretionary spending limits for IRS tax enforcement, compliance, and related activities. These resources would help the IRS continue to target international tax compliance and restore previously reduced enforcement levels. The total cost of supporting new initiatives above the funding needed to maintain current levels of enforcement and compliance activity through 2026 would be approximately \$17.5 billion over the budget window.

This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Revise offer-in-compromise application rules

The administration's FY 2017 budget proposal would repeal a 2006 provision that requires an offer-in-compromise applicant to make certain non-refundable payments as part of its application. The provision would be effective for offers-in-compromise submitted after the date of enactment. This provision was included in the administration's 2016 budget

proposals.

Make repeated willful failure to file a tax return a felony

Under the administration's FY 2017 proposal, any person who willfully fails to file tax returns for three years within any five consecutive year period—if the aggregated tax liability for such period is at least \$50,000—would be subject to a felony and an aggravated failure to file criminal penalty of not more than \$250,000 (\$500,000 in the case of a corporation) or imprisonment for not more than five years or both.

The penalty would be effective for returns required to be filed after December 31, 2016. This provision was included in the administration's FY 2016 budget proposals.

Facilitate tax compliance with local jurisdictions

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

Under the administration's FY 2017 proposal, Indian tribal governments that impose alcohol, tobacco, or fuel excise taxes or income or wage taxes would be treated as states for purposes of information sharing to the extent necessary for tax administration. A tribal government that receives tax information would be required to safeguard it according to prescribed protocols. Criminal and civil sanctions would apply.

The provision would be effective for disclosures made after the date of enactment. This provision was included in the administration's FY 2016 budget proposals.

Improve investigative disclosure statute

The FY 2017 budget proposal includes provisions that would clarify the taxpayer privacy law, by providing that the law would not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The provision would be effective for disclosures made after enactment. This provision was included in the administration's 2016 budget proposals.

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

Currently, the IRS allows a taxpayer to make credit or debit card payments in certain circumstances, but the providers charge the taxpayer a convenience fee over and above the taxes due. Under current law, the IRS is prohibited from absorbing credit or debit card processing fees.

The administration's FY 2017 proposal would amend section 6311(d) to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

The provision would be effective for payments made after the date of enactment. This provision was included in the administration's FY 2016 budget proposals.

Provide the IRS with greater flexibility to address correctable errors

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

The administration's FY 2017 proposal would remove the existing specific grants of math error authority, and provide that "math error authority" will refer only to computational errors and the incorrect use of any table provided by the IRS. In addition, the proposal would add a new category of "correctable errors." Under this new category, Treasury would have regulatory authority to permit the IRS to correct errors in cases when: (1) the information provided by the taxpayer does not match the information contained in government databases; (2) the taxpayer has exceeded the lifetime limit for claiming a deduction or credit; or (3) the taxpayer has failed to include with his or her return documentation that is required by statute.

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

FY 2016 budget proposals.

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 2017 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 in limited circumstances or as otherwise specified in regulations.

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

Impose e-filing mandatory on exempt organizations: The administration's FY 2017 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 grant the IRS discretion to delay the mandate for Form 990-T filers for up to three tax years.

Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a scannable bar code: The administration's FY 2017 proposal would provide the Secretary with authority to require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns

with a scannable bar code to enable the IRS to convert the paper return into an electronic format.

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

Impose a penalty on failure to comply with electronic filing requirements: A return that is required to be e-filed but is instead filed on paper can be treated as a failure to file, but no penalty may result if the corporation is in a refund, credit, or loss position (since the penalty is based on the underpayment of tax). The administration's FY 2017 proposal would establish an assessable penalty for a failure to comply with a specific e-file requirement. The penalty would be \$25,000 for a corporation and partnerships, and \$5,000 for any tax-exempt organization or employee benefit or welfare plan, 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, 2016. These provisions were separately included in the administration's FY 2016 budget proposals.

Improve the whistleblower program

Provide whistleblowers with protection from retaliation: Section 7623 allows whistleblowers to file claims for an award for information that allowed the IRS to detect tax underpayments or detect and bring to trial and punishment persons guilty of violating the internal revenue laws. Other whistleblower statutes, such as the False Claims Act, explicitly provide whistleblowers with protection from retaliatory actions and allow whistleblowers to file claims in U.S. district courts for relief, including reinstatement, back pay, and other damages. There are currently no protections from retaliatory action for whistleblowers who file claims under section 7623. This lack of protection from retaliation may discourage whistleblowers from filing claims with the IRS.

The administration's FY 2017 budget proposal would amend section 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act.

The proposal would be effective upon enactment.

Provide stronger protection from improper disclosure of taxpayer information in whistleblower actions: Section 6103 provides that tax returns and tax return information

are confidential, unless an exception applies. Section 6103(p) imposes safeguarding requirements on certain disclosures of tax return information. In addition, civil and criminal penalties may be imposed on an unauthorized inspection or disclosure of tax return information. Currently, the IRS Whistleblower Office may share tax return information with whistleblowers and their legal representatives in a whistleblower administrative proceeding under section 6103(h) or when the whistleblower and its representatives enter into a written agreement with the IRS under section 6103(n). Whistleblowers and their representatives who receive tax return information under section 6103(n) are subject to the section 6103(p) safeguarding requirements, including civil and criminal penalties for unauthorized inspections and disclosures. The same section 6103(p) safeguards do not extend to information disclosed to whistleblowers under section 6103(h).

The administration's FY 2017 budget proposal would extend the section 6103(p) safeguarding requirements to whistleblowers and their legal representatives who receive tax return information in whistleblower administrative hearings. In addition, the proposal would extend the penalties to unauthorized inspections and disclosures of tax return information to whistleblowers and legal representatives.

The proposal would be effective upon enactment. These provisions were included in the administration's FY 2016 budget proposals.

Index all civil tax penalties for inflation

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

The *Trade Preference Extension Act of 2015*, enacted June 29, 2015, last adjusted certain penalties for inflation—specifically: section 6651 penalty for failure to file a tax return or pay tax; section 6652(c) penalty for failure to file certain information returns; section 6695 return preparer penalty; section 6698 penalty for failure to file a partnership return; section 6699 penalty for failure to file an S corporation return; section 6621 penalty for failure to file correct information returns; and section 6722 penalty for failure to furnish correct payee statements.

The administration's FY 2017 budget proposal would index all civil penalties to inflation (including floors and caps) and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment. This provision was included in the administration's 2016 budget proposals.

Combat tax-related identity theft

Add tax crimes to the aggravated identity theft statute: The “aggravated identity theft statute” under Title 18 of the U.S. Code permits an increased sentence when the identity of another individual is used to commit certain crimes, which currently do not include any tax crimes. A conviction for aggravated identity theft adds two years to the sentence imposed for the underlying felony. The administration’s FY 2017 proposal would subject certain tax-related crimes to the “aggravated identity theft statute.”

The proposal would be effective upon enactment.

Impose a civil penalty on tax identity theft crimes: Tax identity theft has increased exponentially in recent years. Current law does not impose a civil penalty for tax-related identity theft. The administration’s FY 2017 proposal would add a \$5,000 civil penalty on individuals who file a fraudulent return in connection with a tax identity theft case. Under the proposal, the IRS would be able to immediately assess a separate civil penalty for each incidence of identity theft, with no limit on the penalty amount imposed.

The proposal would be effective upon enactment. These provisions were separately included in the administration’s FY 2016 budget proposals.

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

The administration’s FY 2017 budget proposal would remove the statutory requirement to use certified mail, thereby allowing Treasury’s Bureau of Fiscal Service to amend its regulations to permit the States to send notices for delinquent State income tax obligations to debtors by first class mail. The proposal would be effective on the date of enactment. This provision was included in the administration’s FY 2016 budget proposals.

Accelerate information return filing due dates

Many information returns, including Forms 1099, 1098, and 1096, are required to be filed with payees by January 31 and with the IRS by February 28 of the year following the year for which the information is being reported. Third-party information is used by taxpayers to assist them in preparing their income tax returns and used by the IRS to determine a taxpayer’s compliance with federal tax obligations.

The administration’s 2017 budget proposal would 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, 2016. This provision was included in the administration's FY 2016 budget proposals.

Increase oversight of paid tax return preparers

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

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

The proposal would be effective as of the date of enactment. This provision was included in the administration's FY 2016 budget proposals.

Enhance administrability of the appraiser penalty

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

The administration's FY 2017 proposal would replace the existing "more likely than not" exception to the section 6695A appraiser penalty with a reasonable cause exception. In addition, the proposal would coordinate the section 6694 and section 6695A penalties so that an appraiser would not be subject to the penalty under section 6695A if, by reason of that appraisal, the appraiser is also subject to a penalty under section 6694.

The proposal would be effective for returns required to be filed after December 31, 2016. This provision was included in the administration's FY 2016 budget proposals.

SIMPLIFY THE TAX SYSTEM

Modify adoption credit to allow tribal determination of special needs

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

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

The administration’s FY 2017 proposal would amend the tax credit for adoption expenses to allow ITGs to make the status determination of a “child with special needs”, so as to accord ITGs the same deference as state agencies for purposes of the tax credit for adoption expenses.

The proposal would be effective for tax years beginning after December 31, 2016.

Repeal non-qualified preferred stock (NQPS) designation

The administration’s FY 2017 proposal would remove from the Code the designation NQPS and the treatment of such stock as “boot.”

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

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

In enacting the NQPS provisions in 1997, Congress recognized that certain types of preferred stock more appropriately represented taxable consideration because the transferor obtained a more secure form of investment. The administration's FY 2017 proposal embodies a belief that transactions such as those described above may be either inconsistent with Congress's original intent in enacting the provision and/or may otherwise add unnecessary complexity.

The proposal would repeal the NQPS provision in section 351 (and any other cross-referencing provision of the Code) for stock issued after December 31, 2016.

KPMG observation

The administration's FY 2012 through FY 2016 proposals had similar provisions. The reference in the proposal to the use of NQPS in related-party stock sales to avoid deemed dividend treatment is interesting in light of the fact that all stock (whether NQPS or otherwise) is not "property" for purposes of section 304. Thus, it would seem that any stock (regardless of its classification as NQPS or otherwise) may be used to avoid section 304. However, if this change is enacted, NQPS no longer could be used to avoid both section 304 deemed dividend treatment and section 351 nonrecognition treatment with respect to the same transfer if section 351 would be applicable. Thus, the proposal, if enacted, still would limit tax planning opportunities (as well as protect taxpayers from inadvertently planning into a taxable exchange) related to the use of NQPS in related-party stock sales.

Reform excise tax based on investment income of private foundations

The administration's FY 2017 proposal would impose a single tax rate of 1.35% on tax-exempt private foundations. For private foundations that are not exempt from federal income tax, the amount of tax would equal any excess 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 amount of income tax imposed on the foundation. The proposal would also repeal the special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions.

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

Streamline private activity limits on governmental bonds

Currently, section 141 treats tax-exempt bonds issued by state and local governments as governmental bonds if the issuer limits private business use and other private involvement sufficiently to avoid treatment as "private activity bonds." Bonds generally are classified as private activity bonds if more than 10% of the bond proceeds are both used for private business use, and (2) payable or secured from property or payments derived from private business use. Section 141(b)(3) reduces the 10% threshold to 5% when testing for unrelated

or disproportionate private business use. Section 141(b)(4) imposes a \$15 million cap on private business involvement for governmental output facilities (such as electric, gas, or other output generation, transmission, and distribution facilities, but excluding water facilities). Section 141(c) imposes a private loan limit equal to the lesser of 5% or \$5 million of bond proceeds. Finally, section 141(b)(5) requires a volume cap allocation for private business involvement that exceeds \$15 million in larger transactions which otherwise comply with the general 10% private business limits.

To simplify the private business limits on tax-exempt governmental bonds, the administration's FY 2017 proposal would repeal the 5% unrelated or disproportionate private business use test and the \$15 million private business cap on nongovernmental output facilities. In addition, the proposal would modify the private loan limit under section 141(c) to limit private loans to no more than 10% of the bond proceeds. The proposal would retain the overall volume cap requirement for private involvement of \$15 million in larger governmental bond issues as an overall constraint, and would apply it to both private business use and private loans. The proposal would be effective for bonds issued after the date of enactment.

Repeal technical terminations of partnerships

Under current law, a partnership can "technically terminate" under section 708(b)(1)(B) if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in both partnership capital and partnership profits. If a partnership technically terminates, certain events are deemed to take place to effectuate the tax fiction that the "old" partnership has terminated and a "new" partnership has begun.

Similar to the FY 2015 and 2016 proposals, the administration's FY 2017 proposal would repeal the technical termination rule of section 708(b)(1)(B), effective for transfers after December 31, 2016.

KPMG observation

Technical terminations can raise significant federal tax issues, many of which can be unfavorable from a taxpayer's perspective, but some of which can be favorable in particular fact situations. In addition, technical terminations raise compliance considerations. As a result, under current law, it can be important for partnerships to monitor sales and exchanges of their interests to determine if technical terminations may be triggered and to assess the consequences of such terminations based on their particular facts. Repealing the technical termination rules would reduce compliance burdens and would eliminate consequences—favorable and unfavorable—that can result in particular cases.

Repeal anti-churning rules of section 197

Since 1993, taxpayers have been allowed under Section 197 to amortize the costs of acquiring certain intangible assets, including goodwill and going concern value, over a 15-year period, even if the asset does not have a determinable useful life. Section 197 has not applied, however, to certain intangibles – including goodwill and going concern value – that were not amortizable under prior law if:

- The intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the “transition period”) by the taxpayer or a related person;
- The taxpayer acquired the intangible from a person who held it at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or
- The taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

The administration’s FY 2017 proposal is similar to its FY 2016 proposal and would repeal the anti-churning rules in section 197(f)(9) effective for acquisitions after December 31, 2016.

Repeal special estimated tax payment provision for certain insurance companies

The administration’s FY 2017 proposal would repeal section 847, which allows for a deduction for certain special estimated tax payments, effective for tax years beginning after December 31, 2016. Taxpayers may elect to include any balance in the special loss discount account balance as of December 31, 2016, in gross or ratably over a four-year period.

KPMG observation

This provision, which is revenue neutral and is designed to reduce recordkeeping burdens, is consistent with former Ways and Means Chairman Camp 2014 tax reform bill and was included in the administration’s FY 2011 through FY 2016 revenue proposals.

Repeal the telephone excise tax

Similar to last year, for periods beginning 90 days after enactment of a repeal, the administration’s FY 2017 budget would repeal all federal excise taxes on communications services, including the tax on local telephone service.

Increase the standard mileage rate for automobile use by volunteers

The administration’s FY 2017 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 to reflect the variable costs of operating a vehicle.

The proposal would be effective for tax years beginning after December 31, 2016.

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 2017 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 contributions made in tax years beginning after December 31, 2016.

Exclude from income subsidies for purchase of water runoff management

Under current law, subsidies paid to an individual by a water utility for the purchase of water conservation measures generally are included in the gross income of the individual under section 61.

The proposal would exclude, from the gross income of any individual, the value of a subsidy provided by a public utility for the purchase of qualifying water conservation or storm water management measures. Qualifying measures include items that reduce water consumption, manage storm water runoff in a dwelling, and several other categories.

The proposal would exclude from gross income subsidies provided after December 31, 2016.

Provide relief for certain accidental dual citizens

An individual can become a U.S. citizen at birth either by being born in the United States (or certain territories or possessions) or by having a parent who is a U.S. citizen. Some individuals only become aware as adults that they have been U.S. citizens since birth.

Because U.S. citizens are subject to U.S. income tax on their worldwide income even if they reside abroad, and can also be subject to information reporting obligations, many such individuals wish to relinquish their U.S. citizenship.

Section 877A of the Code imposes a mark-to-market tax on the worldwide assets of individuals who relinquish their U.S. citizenship if they meet a tax liability test (\$161,000 in 2016), a net worth test (\$2 million), or if they fail to certify their compliance with U.S. federal tax obligations for the five preceding tax years (the “certification test”).

Section 877A provides an exception from the tax liability and net worth tests for certain dual citizens who have had minimal contacts with the United States during the 15 years preceding the relinquishment of their U.S. citizenship. Such individuals, however, remain subject to the certification test.

The administration’s FY 2017 proposal would exempt an individual from the mark-to-market tax if the taxpayer meets the following conditions:

- The taxpayer became at birth a citizen of the United States and a citizen of another country
- At all times, up to and including the individual’s expatriation date, the taxpayer has been a citizen of a country other than the United States
- The taxpayer has not been a resident of the United States (as defined in section 7701(b)) since attaining age 18½ years
- The taxpayer has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with immigration regulations requiring use of a U.S. passport
- The taxpayer relinquishes his U.S. citizenship within two years after the later of January 1, 2017, or the date on which the individual learns that he is a U.S. citizen
- The taxpayer certifies under penalty of perjury his compliance with all U.S. federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period

The proposal would be effective after December 31, 2016.

KPMG Observation

Many dual-citizen individuals living outside the United States could be at risk of penalties under U.S. tax law for failure to disclose their ownership of foreign financial assets by filing annual information returns such as Form 8938, *Statement of Specified Foreign Financial Assets*. These filing obligations generally apply only to U.S. citizens and residents, and not to nonresidents. The administration’s proposal would mitigate this penalty risk

by requiring that such individuals only to certify their compliance with the obligations that apply to nonresidents as opposed to the obligations that apply to U.S. citizens and residents.

USER FEE

Reform inland waterways funding

Similar to last year, the administration's FY 2017 budget would modify the laws governing the Inland Waterways Trust Fund, including establishing a new user fee to fund the trust fund. Specifically, the proposal would increase the amount paid by commercial navigation users to meet their share of the costs of activities financed from the trust fund. The proposal would direct the Secretary of the Army to establish the necessary amount of a new user fee each so as to collect a total of \$1.1 billion over the first 10 years. After the 10-year period, the user fee would be adjusted as needed, so that the combined amount collected from the current excise tax and the user fee would sufficiently fund the user-financed share of spending for inland waterways construction, replacement, expansion, and rehabilitation work, described below. The proposal would also expand the list of waterways subject to the inland waterways excise tax.

The proposal would be effective for vessels used in commercial waterway transportation beginning after September 30, 2016.

OTHER INITIATIVES

Allow offset of federal income tax refunds to collect delinquent state income taxes for out-of-state residents

Generally, an overpayment of federal tax due a taxpayer may be reduced by (i.e., offset by) debts of the taxpayer for past-due child support, debts to federal agencies, fraudulently obtained unemployment compensation, and past-due, legally enforceable state income tax obligations. However, a delinquent taxpayer can escape offset of a federal refund for a state tax liability if the taxpayer is not a resident of the state.

The proposal would permit offset of federal refunds to collect state income tax, regardless of where the delinquent taxpayer resides.

The proposal would be effective on the date of enactment. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Improve disclosure for child support enforcement

Tax return information is confidential and may not be disclosed without a specific exception under the Code. Generally these exceptions are limited to disclosures related to tax administration; however, in certain cases tax return information may be disclosed for certain limited but important purposes other than tax administration. Although section 6103(l) permits some disclosure of certain tax information to federal, state, and local child support enforcement agencies, current law in this area is complex and diffuse and often crosses jurisdictional lines. This results in prohibitions on the sharing of some information with parties that are integral to child support enforcement because these parties are not currently authorized recipients of tax return information. The inability to disclose the tax return information to these parties and in these circumstances hampers the effective operation of child support enforcement activities.

The proposal—new in the FY 2017 budget—would amend section 6103(l) to consolidate the child support enforcement disclosure rules into a single provision, define key terms, permit disclosure to critical entities, and update and streamline the items of tax return information that may be disclosed to each entity depending on the purpose and need for the disclosure. It also clarifies the allowed uses of this information and safeguarding responsibilities of tax return information recipients.

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

Authorize the limited sharing of business tax return information to improve the accuracy of important measures of the economy

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

The administration's FY 2017 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 and 2016 revenue proposals.

Eliminate certain reviews conducted by the U.S. Treasury Inspector General for Tax Administration (TIGTA)

Section 7803(d) requires TIGTA to conduct reviews of certain administrative and civil actions and reviews of the IRS compliance with respect to certain requirements in order to comply with TIGTA's reporting requirements.

As requested by TIGTA, the proposal would eliminate TIGTA's obligation to do statutory reviews that are of relatively low value and yield little in the way of performance measures.

The administration's FY 2017 proposal would revise the annual reporting requirement for all remaining provisions in the *IRS Restructuring and Reform Act of 1998* to a biennial reporting requirement.

The proposal would be effective after December 31, 2016. It was included in a previous revenue proposal.

This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Modify indexing to prevent deflationary adjustments

Under current law, many income tax amounts, brackets, thresholds, and other parameters are indexed for inflation. In some situations, if an inflation index declines, the relevant parameter would decline. In other situations, the parameter would not be reduced if the index declined. In 2008 and 2009, two of the index values or indices used in adjusting various parameters declined. In one situation, the relevant amount was statutorily held steady; in the other, a dollar limitation declined.

The administration's FY 2017 proposal would modify inflation adjustment provisions to prevent any tax parameters from declining from the previous year's levels if the underlying price index falls. Future inflation-related increases would be based on the highest previous level of the price index relevant for adjusting the particular tax parameter.

The proposal would be effective beginning on the date of enactment. This provision was included in the administration's FY 2016 revenue proposal.

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