

FY 2016 budget blueprint reflects president’s call for business tax reform, infrastructure spending, middle-class tax relief

President Obama on February 2 released a budget blueprint for fiscal year 2016 that builds on the corporate tax reform framework he unveiled in 2012 and the middle-class economics agenda that he previewed in his most recent State of the Union message.

The budget proposal calls for a cut in the top corporate tax rate to 28 percent – 25 percent for “advanced manufacturing” companies – as well as incentives to promote domestic manufacturing, research and development, small businesses, and alternative energy. The rate cut and new incentives would be offset by largely familiar proposals to scale back or eliminate current-law tax expenditures benefiting U.S. multinationals, large corporations, the fossil fuel industry, and large financial institutions. Significantly, the budget also calls for changing the tax treatment of multinationals – and moving the U.S. toward a territorial tax system – through a new minimum tax on foreign earnings of domestic multinationals and their controlled foreign subsidiaries along with a one-time repatriation tax on previously untaxed foreign earnings. A portion of the revenue from the repatriation tax would be allocated to a one-time investment in infrastructure spending.

On the individual side, the budget package builds on proposals the president previewed in the days leading up to his State of the Union message that call for tax relief and spending targeted at low- and middle-income workers and families, paid for by tax increases mainly on wealthy individuals and large financial institutions.

Although many of the proposed tax relief provisions and revenue offsets are carried over from previous Obama administration budget plans, the current blueprint includes several significant new revenue provisions.

***This report will focus primarily on significant revenue provisions and tax incentives that have not appeared in prior Obama administration budget proposals.*** Descriptions are based on details in the so-called “Greenbook” which provides the Treasury Department’s explanations of the revenue provisions in the budget proposal.

Projected debt and deficit picture

According to estimates from the White House Office of Management and Budget, the president’s budget blueprint calls for nearly $44.7 trillion in revenue and some $50.3 trillion in spending over the 10-year budget window (fiscal years 2016-2025).

As projected in the budget, total revenues as a share of gross domestic product (GDP) would rise from 17.7 percent in fiscal 2015 to 19.7 percent in fiscal 2025, for an average of 19.3 percent over the 10-year budget window; outlays would rise from 20.9 percent of GDP in 2015 to 22.2 percent in 2025, for a 10-year average of 21.7 percent. (In the 10-year budget and economic outlook it released last month, the Congressional Budget Office (CBO) reported that over the past 50 years – 1965-2014 – U.S. revenues have averaged 17.4 percent of GDP and outlays have averaged 20.1 percent of GDP.)

The budget anticipates a fiscal year 2015 deficit of $583 billion, or 3.2 percent of GDP. The deficit is projected to fall to 2.3 percent of GDP for 2017 and 2018, rise to 2.4 percent in 2019, and hover between 2.4 percent and 2.6 percent through 2025, resulting in an average deficit of 2.5 percent of GDP over the 10-year window. Debt held by the public – a frequently cited metric of the level of government indebtedness – is projected at 75.1 percent of GDP for fiscal year 2015 and is expected to decline slightly every year thereafter before dropping to 73.3 percent of GDP by 2025. (According to CBO, the 50-year historical average for deficits is 2.7 percent of GDP, and the 50-year average for publicly held debt is 38 percent of GDP.)

Notable new revenue proposals affecting multinationals

The administration, along with proposing a reduction in the corporate tax rate from 35 percent to 28 percent, has called for significant changes to the U.S. international tax rules. However, unlike prior budgets, the FY 2016 budget proposes the fundamental reform of the U.S. international tax rules to eliminate the “lock-out” effect of current law and depart from the primary reliance on foreign tax credits as the means to prevent international double taxation. The administration’s proposal generally calls for (1) a 100 percent exemption on dividends from controlled foreign corporations (CFCs), (2) a 19 percent worldwide minimum tax on foreign earnings, and (3) a 14 percent tax on pre-effective date earnings of CFCs as a one-time transition tax into the new regime (the transition tax).

The rate at which the transition tax is imposed in this proposal is much higher than the rates proposed by former House Ways and Means Committee Chairman Dave Camp, R-Mich., in the tax reform discussion draft he unveiled in February of 2014 and formally introduced as H.R. 1 last December (the Camp proposal); however, the effective tax rate on future CFC earnings proposed by the administration may be more similar than anticipated to rates under the Camp proposal.

The administration has jettisoned some of its longstanding budget items in the FY 2016 blueprint because they would no longer be relevant under a dividend exemption system with a minimum tax. The FY 2016 budget would make the international tax extenders (i.e., the active financing exception and CFC lookthrough rules) permanent.

In general, the proposals would take effect for tax years beginning after December 31, 2015.

**19 percent minimum tax on foreign earnings:** The FY 2016 budget proposal generally eliminates the U.S. taxation of dividends received by corporate U.S. shareholders from CFCs and in its place would generally seek to ensure that at least a 19 percent worldwide tax is imposed on CFCs’ earnings. This same treatment would generally apply to income of a foreign branch of a domestic corporation. CFC earnings would no longer be taxed to U.S. shareholders on the basis of CFC investments in U.S. property.

The minimum tax rate would not apply to subpart F income, which would continue to be subject to current U.S. tax at the full U.S. tax rate. Thus, for U.S. corporate shareholders all CFC earnings would be subject to immediate U.S. taxation at either full U.S. rates for subpart F income or the residual minimum tax rate (if greater than zero) for non-subpart F income.

Under the proposal, foreign earnings would be subject to current U.S. taxation to ensure a per-country minimum rate of taxation of 19 percent on all current foreign earnings of CFCs and foreign earnings of a U.S. corporation from a foreign branch or the performance of services abroad, less an “allowance for corporate equity” (ACE) that would exempt from U.S. tax a risk-free rate of return on equity invested in active assets. The residual (U.S.) minimum tax rate on earnings assigned to a particular foreign country would be computed by subtracting 85 percent of that country’s foreign effective tax rate from the 19 percent tentative minimum tax rate. Interest expense allocated and apportioned to foreign earnings subject to the minimum tax would be deductible at the residual U.S. tax rate applicable to those earnings, if any.

A taxpayer’s foreign effective tax rate for a country would be computed on an aggregate basis for all foreign earnings and associated taxes assigned to that country over a 60-month period based on tax residence in that country under foreign law. If the same earnings are subject to tax in multiple jurisdictions, such earnings would be assigned to the jurisdiction with the highest tax rate.

There would be no U.S. tax on the sale of stock in a CFC to the extent the gain reflects undistributed earnings of the CFC already subject to minimum tax, subpart F, or the transition tax.

The administration estimates that the proposal would raise almost $206 billion over 10 years.

The proposal is the administration’s response to tax reform proposals in Congress, which include a shift to a territorial system of taxing offshore income. As a result of allowing only 85 percent of the foreign effective tax rate to reduce the 19 percent minimum tax, taxpayers could pay as much as 22.35 percent worldwide and could suffer some double taxation unless the allowance for corporate equity is at least 15 percent of pre-ACE-deduction earnings that are used to compute the foreign effective tax rate.

It appears the administration intends for section 902 to be repealed under the proposal because dividends would be 100 percent exempt from additional U.S. tax. As a result, and as under other territorial systems, low-taxed or nontaxed foreign-source income (such as interest and royalties) would no longer be sheltered by excess foreign income taxes that are deemed paid in connection with dividends under present law.

The proposal further indicates that to the extent a foreign branch’s income is related to intellectual property, there will be a deemed royalty from the foreign branch to the U.S. corporation, and only foreign branch earnings net of the deemed royalty would be subject to the benefit of the minimum tax rate. The deemed royalty income would be subject to U.S. tax at full rates.

It is also important to note that with respect to a U.S. corporate shareholder’s interests in non-CFCs, the foreign earnings of a non-CFC would not be subject to the minimum tax and thus dividends received from non-CFCs would not be eligible for the 100 percent dividend exemption. Because the minimum tax applies only to U.S. corporate shareholders of CFCs, it appears that pre-existing current law would continue to apply to any individual U.S. shareholders of CFCs.

**14 percent transition tax on accumulated foreign earnings:** In connection with the transition to the minimum tax, the FY 2016 budget proposal would impose a one-time 14 percent (40 percent of current U.S. tax rate) transition tax on earnings accumulated in CFCs and not previously subject to U.S. tax. Foreign tax credits would be permitted to reduce the U.S. tax liability, limited to the amount of credits associated with such earnings multiplied by 40 percent (14 percent/35 percent). The proposal is unclear on whether the transition tax would be imposed on a separate company basis or a pooled basis, and thus whether CFCs with accumulated earnings deficits would be able to offset CFCs with positive accumulated earnings. The tax due on the accumulated earnings would be payable ratably over five years.

The accumulated earnings subject to the transition tax could be repatriated exempt from further U.S. tax.

The transition tax would apply to earnings accumulated for taxable years beginning before January 1, 2016. According to the administration, this proposal would raise $268 billion over 10 years, of which $238 billion would be set aside to fund infrastructure spending and the remaining $30 billion used for deficit reduction.

A similar transition tax introduced in the Camp proposal would tax accumulated earnings and profits (E&P) at a 3.5 percent rate, and accumulated E&P held in the form of cash or cash equivalents at an 8.75 percent rate, with an eight-year installment period to pay the tax liability. The administration’s proposal imposes a higher tax rate and shorter payback period for taxpayers, while failing (unlike the Camp proposal) to take into account that not all earnings are associated with liquid assets. The administration proposal, like the Camp proposal, does not impose an interest charge on the deferred tax.

The impact the transition tax could have on earnings for companies that assert the permanent reinvestment of foreign earnings under U.S. GAAP principles should also be considered.

**Repeal delay of worldwide interest allocation:** This proposal would make available the worldwide affiliated group election under section 864(f) for allocating interest expense deductions between U.S. and foreign-source gross income, effective immediately. While section 864(f) was originally enacted for taxable years beginning after December 31, 2008, subsequent legislation deferred the election until tax years beginning after December 31, 2020.

The administration estimates this proposal would raise the deficit $12.2 billion over 10 years.

The election under section 864(f) would be beneficial to the taxpayer by reducing the amount of interest expense allocated against foreign-source income, and thus would reduce the amount of interest expense that must be deducted at the lower U.S. residual minimum tax rates applicable to such income under the minimum tax proposal.

**Anti-inversion proposal:** The budget includes a revised version of the anti-inversion provision the administration proposed in FY 2015. For transactions that are completed after December 31, 2015, the revised proposal would, like last year’s, amend section 7874 to reduce the current 80 percent continuity-of-ownership test (for determining whether a new foreign parent would be treated as domestic for U.S. tax purposes post-inversion) to a greater-than-50 percent test and eliminate the 60 percent test entirely. However, this proposal adds a special rule providing that an inversion transaction would be deemed to occur – regardless of the continuity of ownership – if:

* Immediately before the acquisition, the fair market value of the stock of the domestic entity is greater than that of the foreign acquirer;
* The expanded affiliated group (EAG) is primarily managed and controlled in the United States; and
* The EAG does not conduct substantial business in the country where the foreign acquirer is created or organized.

The IRS would be given the authority to share tax return information with other federal agencies for the purpose of administering anti-inversion rules with an effective date of January 1, 2016, regardless of when the inversion transaction occurred.

The administration estimates this proposal would increase revenues by $12.7 billion over 10 years.

Relative to last year’s proposal, the FY 2016 proposal significantly clarifies and narrows the scope of the new anti-inversion rules that would apply regardless of continuity of shareholder ownership, because the FY 2016 proposal would expressly exclude transactions where foreign corporations acquire smaller (by value) domestic entities from being classified as inversion transactions absent sufficient continuity of shareholder ownership.

**State corporate income tax considerations:** Many state corporate income tax regimes are affected by federal tax law changes because, for administrative ease, such state regimes “piggy-back” off of the Internal Revenue Code (IRC) by either incorporating the IRC in whole or in part, or by using federal taxable income as the starting point. States with automatic or “rolling” conformity generally will adopt such changes unless there is specific state legislation enacted to decouple from federal law. Other states adopt the IRC as of a specific date, do not adopt the code provisions in totality, or provide modifications or exceptions to certain adopted provisions.

Two of the multinational proposals in the FY 2016 budget package – the 19 percent minimum tax on foreign income and the 14 percent transition tax on accumulated foreign earnings – may, if adopted, have a state tax effect that could vary based on whether each of these proposed federal changes is considered a deemed repatriation of income (dividend) or a special surcharge. Because the state tax base and the IRC are often heavily intertwined, deemed dividend treatment may increase both the federal and state income tax base. However, foreign dividends are often fully or partially excluded from the state tax base through a dividends received deduction. As a result, the proposed federal minimum tax and deemed repatriation tax, if treated as a dividend for state purposes, may marginally impact states with automatic or “rolling” conformity.

However, if the proposed minimum tax and deemed repatriation tax are each considered to be a surcharge, thus not impacting the federal income tax base for state income tax purposes, then there may not be a state tax effect unless such federal changes serve as impetus for analogous state law changes. For example, fundamental shifts in federal tax policy may cause states to reevaluate their own tax policy in an effort to address perceived state tax revenue loss resulting from international business structures. In this manner, the proposed federal minimum tax and deemed repatriation tax may, in an effort to impose federal tax on foreign earnings through the adoption of a special tax regime, serve to encourage states to adopt similar state tax schemes directed at imposing tax on foreign earnings.

Revenue raisers affecting upper-income individuals

The president’s budget proposal includes two major new revenue-raisers that would reform the taxation of capital gain income for certain individuals – both during a taxpayer’s lifetime and at death – and redirect the savings into tax relief and spending targeted at low- and middle-income workers and families.

**Increase the top rate on long-term capital gains, qualified dividends:** Under current law, the top rate on long-term capital gains and qualified dividends is 20 percent. That rate applies to taxpayers in the highest marginal income tax bracket of 39.6 percent which, in 2015, begins at $413,200 for a single taxpayer and $464,850 for a married couple filing jointly. Other taxpayers face a rate of either zero or 15 percent, depending upon their income.

Additionally, pursuant to the Patient Protection and Affordable Care Act of 2010, a 3.8 percent surtax on net investment income – including capital gains and dividends – applies to individuals and couples whose modified adjusted gross income exceeds $200,000 and $250,000, respectively.

The president’s plan would increase the top rate on long-term capital gains and qualified dividends from 20 percent to 24.2 percent. Together with the 3.8 percent surtax on net investment income, the total top rate on such income therefore would rise to 28 percent.

The proposal would be effective for capital gains realized and qualified dividends received in taxable years beginning after December 31, 2015.

**Eliminate stepped-up basis for appreciated assets at death, tax donors currently on gifted appreciated property:** Under current law, every asset received from a decedent is either “stepped up” to its appreciated value at the date of death or “stepped down” to its depreciated value at the date of death for purposes of determining the heir’s basis in the asset. However, a recipient of gifted property made during the donor’s lifetime generally (but not always) takes “carry-over” basis – i.e., the donor’s basis at the time of the transfer. Capital gain or loss, if any, is not recognized by the heir or donee, as applicable, until the asset is subsequently disposed of prior to the death of the donee.

Under the president’s proposal, transfers of appreciated property – whether by a decedent at death, or by gift during a donor’s lifetime – generally would be treated as a sale of the property. (Presumably, with respect to depreciated assets, the step-down or modified carryover basis rules would continue to apply, implying that a recognized loss would not be available to offset a recognized gain.) As a result, a donor or decedent transferring an appreciated asset generally would recognize gain at the date of gift or the date of death, as applicable. In the case of a decedent, the gain would be reportable on the final income tax return, and the related income tax liability would be deductible on the estate tax return (if one must be filed). (While the proposal implies that the gain would be capital gain, it is anticipated that, under existing income tax rules, ordinary income would also be recognized – for example, if depreciation recapture is recognized or when a partnership having a negative capital account is transferred.) Interestingly, the proposal’s language implies that following enactment, any unused capital loss carryforwards that would expire under current law, would be allowed to offset ordinary income in the final individual income tax return.

Consistent with existing gift and estate tax rules, the proposal provides exceptions to the gain recognition rule if the donee is a charity or the transferor’s spouse. In such cases, carry-over basis would apply. With respect to the marital transfer exception, capital gain would not be realized until the transferee disposed of the asset by sale, further gift, or at death. Similarly, current income tax exclusions related to the sale of small business stock would also be applicable upon a deemed sale.

The proposal would allow a $100,000 per-person exclusion with respect to capital gains recognized by reason of death, which would be indexed for inflation and portable between spouses, resulting in a total exclusion of $200,000 per couple that would increase over time. Similarly, an indexed portable exclusion of $250,000 per person would apply to capital gain on personal residences, resulting in a total exclusion of $500,000 per couple that would increase over time. Although unclear, the language implies that the exception would apply only to the transferor’s principal residence. The proposal further implies that capital gains recognized by reason of a gift are not offset by either the $100,000 or $250,000 exclusion amounts. The proposal also would exempt gain on tangible personal property and personal effects – except for collectibles. While the rule is clearly intended to avoid the need for appraisals of the artifacts of daily life, what constitutes a collectible is not defined.

According to the proposal, tax otherwise due on account of transfers of small family-owned and operated businesses could be electively deferred (presumably by utilizing the carry-over basis rules that would apply to marital and charitable transfers) until the business is sold or ceases to be family-owned, which, somewhat counterintuitively, implies that the tax could arise other than by a sale to an unrelated party. (During testimony before the Senate Finance Committee on February 5, Treasury Secretary Jack Lew explained that this option would be available to businesses “under $1 million,” although he did not specify whether this threshold refers to the value of a business, its total assets or revenues, or some other measure.) Additionally, except for liquid assets (e.g., publicly traded stocks and bonds) and businesses for which the previously mentioned deferral election is made, a 15-year fixed-rate payment plan would be available with respect to tax due on the deemed sale of illiquid appreciated assets transferred at death – presumably to avoid the need to liquidate appreciated illiquid assets. While any tax deferral would bear interest, the tax deductibility of such interest is not discussed; however, the proposal does mention that lien provisions would be operative while the tax is deferred. Last but not least, the proposal suggests that rules would be enacted that would achieve “consistency in valuation for transfer and income tax purposes.” While the full scope of that language is not explored, it portends a renewed assault on the discounting of assets.

The proposal would be effective for gifts made, and decedents dying, after December 31, 2015.

According to the administration, the increased top rate on long-term capital gains and qualified dividends and accelerated recognition of capital gain income by certain decedents and donors would increase federal receipts by a combined total of almost $208 billion over the next 10 years.

**Returning provisions:** In additions to these new provisions, the administration has re-proposed a number of individual tax revenue raisers that appeared in previous budget packages. These include, among others, provisions that would:

* Implement the so-called “Buffett Rule” – now referred to as the “Fair Share Tax” – which would require households with incomes over $1 million to pay at least 30 percent of their income (after charitable giving) in taxes.
* Cap the value of itemized deductions and certain income exclusions for high-income taxpayers at 28 percent.
* Restore the estate tax parameters to those in effect in 2009 – i.e., a 45 percent top rate and a $3.5 million exclusion. (Under the president’s plan, the exclusion amount would not be indexed for inflation, but would be portable between spouses.)
* Tax income from carried interests at ordinary rates;
* Limit tax benefits for high-balance, tax-favored retirement plans;
* Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years;
* Expand the Earned Income Tax Credit for workers without qualifying children.

New tax breaks targeted at low- and middle-income individuals

The president’s plan would redeploy the savings from his proposed reforms to the individual capital gain rules – along with revenue generated by a new fee on large financial institutions (discussed elsewhere in this publication) and proposals from previous budget plans targeting high-balance tax-preferred retirement plans and self-employment tax compliance by certain professional service businesses – into tax relief and spending targeted at low- and middle-income workers and families.

**Reform child care tax incentives:** Under current law, working families are eligible for a Child and Dependent Care Tax Credit (CDCTC) for expenses incurred for the care of a child under age 13, or a disabled dependent of any age with the same place of abode as the taxpayer. The credit is equal to between 20 and 35 percent of qualified care expenses up to $3,000 for one child/dependent and $6,000 for two or more children/dependents. The 35 percent credit rate begins to phase down at adjusted gross income (AGI) over $15,000 and reaches 20 percent once AGI exceeds $43,000.

Separately, the tax code allows households regardless of income to set aside up to $5,000 ($2,500 if married filing separately) of their salary each year on a pre-tax basis (both with respect to income and payroll tax) in a dependent care flexible spending account (FSA). Distributions from a dependent care FSA generally are not taxable provided the funds are used to pay for qualified dependent care expenses. In any given year a taxpayer cannot claim the CDCTC for child care expenses to the extent the taxpayer has made pre-tax contributions to a dependent care FSA.

The president’s plan would repeal dependent care FSAs in favor of an expanded CDCTC. Specifically, the proposal would make the maximum credit rate of 35 percent applicable to households with income up to $120,000 (indexed for inflation). Further, with respect to children under 5 years old, the CDCTC would be increased to 50 percent of qualified child care expenses up to $6,000 for one child and $12,000 for two or more children.

According to the administration, these reforms on net would reduce federal receipts by roughly $50 billion over 10 years. The proposals would be effective for taxable years beginning after December 31, 2015.

**Reform tax benefits for education**: Current law includes several tax preferences designed to encourage private saving for education and to offset costs incurred in the pursuit of higher education. (Note: All of these provisions, with the exception of section 529 plans, are currently phased out for higher-income households.)

* **Section 529 Qualified Tuition Plans –** Earnings on funds contributed to a section 529 plan grow tax-free; distributions are untaxed if spent on qualified higher education expenses;
* **Coverdell Education Savings Accounts –** Similar to section 529 plans, but distributions may also be used to pay for elementary and secondary education;
* **Student loan interest deduction –** Maximum $2,500 above-the-line deduction for interest on loans used to finance higher education;
* **American Opportunity Tax Credit (AOTC) –** Maximum $2,500, partially refundable credit for qualified higher education expenses; available for first four years of postsecondary education; scheduled to expire for expenses incurred after December 31, 2017); and
* **Lifetime Learning Credit –** Maximum $2,000 nonrefundable credit for qualified higher education expenses; available for all years of postsecondary education in which the AOTC is not claimed.

The president’s plan would eliminate or reform several of these preferences in favor of a permanent and expanded AOTC. Specifically, the plan would repeal – prospectively – the student loan interest deduction, the Lifetime Learning Credit, and Coverdell plans, while at the same time indexing to inflation the expense limits used to calculate the AOTC. The plan would also boost the maximum refundable portion of the AOTC from $1,000 to $1,500 (and index it to inflation), allow the credit to be claimed in five tax years (as opposed to four years under current law), and make part-time students eligible for a reduced AOTC.

Relative to the budget’s baseline, which assumes the current-law AOTC is permanently extended beyond its scheduled December 31, 2017, expiration date, the administration estimates these reforms would on net cost roughly $46 billion over 10 years. The president’s proposed education tax reforms generally would be effective for taxable years beginning after December 31, 2015.

**Section 529 proposal dropped:** Although the budget documents released by the administration also include a proposal that would eliminate the tax-free status of certain distributions from section 529 plans, the administration indicated on January 27 that it was withdrawing that particular proposal due to bipartisan opposition in Congress.

**Provide a new tax credit for two-earner households:** For the first time, the president is proposing to establish a nonrefundable “second-earner” tax credit of up to $500 for two-earner households. The credit – which the administration says is designed to counter economic disincentives to having both spouses work, particularly for parents of young children – would be computed as 5 percent of the lower earner’s income up to $10,000. It would be phased out on joint AGI between $120,000 and $210,000.

This provision is estimated to reduce revenues by roughly $90 billion over 10 years. It would be effective for taxable years beginning after December 31, 2015.

**Incentives from prior budget proposals:** In addition to these new proposals, the president’s plan also includes proposals from past budget blueprints that would (1) increase the Earned Income Tax Credit for workers without dependent children, and (2) expand access to tax-advantaged workplace savings plans by requiring employers in business for at least two years with more than 10 employees and which presently do not offer a retirement plan to automatically enroll workers in an Individual Retirement Arrangement (the so-called “auto-IRA” proposal).

Fee on financial institutions

Similar to past budgets, the administration proposes to levy a fee on large financial institutions operating in the United States, including foreign institutions. This year’s version would apply a fee of 7 basis points (.07 percent) on certain liabilities of financial institutions with worldwide consolidated assets of more than $50 billion. According to the Treasury explanation, financial institutions would include banks, insurance companies, exchanges, asset managers, and broker-dealers. The fee would be deductible for corporate income tax purposes.

The proposal would be effective January 1, 2016. The administration estimates this provision would increase federal revenues by almost $112 billion over 10 years, which is double the estimate of last year’s proposal.

Insurance company provisions

**Proration rules for life insurance company general and separate accounts:** In past budgets the administration has proposed modifying the proration rules for life insurers’ general and separate accounts. Previous budgets had proposed a fixed 15 percent proration, but this year’s budget proposes a different regime that the administration says will be simpler than the current system. As in current law, a company’s share and policyholders’ share would be calculated for the company’s general account and individually for each of its separate accounts. But according to the Treasury explanation, the policyholders’ share would be equal to a “ratio of an account’s mean reserves to its mean assets,” while the company’s share would equal “one less the policyholders’ share.” The proposal would be effective for taxable years after 2015 and would increase revenue by $7.5 billion by 2025.

**Net operating losses of life insurance companies**: A new proposal would conform the rules for net operating losses (NOLs) of life insurance companies to other corporations. Currently, life insurers are may carry back a loss from operations (a life company’s equivalent of an NOL) for up to three years then carry it forward for 15. The proposal would align the treatment of a loss from operations to that of other businesses: carryback for up to two years then a 20-year carryforward. The proposal would be effective after 2015 and would increase revenues by about $300 million over 10 years.

Information reporting

**Enhanced reporting for mortgage interest:** In addition to past information reporting proposals to improve compliance, the administration adds a few new provisions, the most significant of which would require enhanced Form 1098 reporting for mortgage interest to include outstanding principal amounts, address of the property, refinancing information, taxes paid from escrow, and the loan origination date. This provision would begin in 2016 and would increase revenues by about $1.9 billion over 10 years.

Energy provisions

**Fossil Fuel PTPs:** As it has done in past budgets, the administration again proposes eliminating fossil fuel preferences, but it adds a new provision this year that would treat fossil-fuel publicly traded partnerships (PTPs) as C corporations for income tax purposes. This proposal, however, would not apply to these PTPs until 2021. It would raise about $1.7 billion in revenue in the last five years of the budget window.

**Carbon dioxide sequestration:** The budget proposes authorization of $2 billion to be allocated to a new and refundable investment tax credit for carbon dioxide sequestration. According to the Greenbook, the credit would be available to new and retrofitted electric generating units. To be eligible for the credit, units would be required to capture more than 75 percent of their carbon dioxide emissions, while retrofits would also be required to apply to existing plants with capacities of greater than 250 megawatts and that capture and store more than 1 million metric tons of carbon dioxide annually. The proposal would be effective on date of enactment and is estimated to increase the deficit by $5 billion over 10 years.

Small business provisions

**Uniform definition of a small business for accounting purposes:** The administration notes that current-law rules have differing requirements for small-business exceptions, and it says a uniform definition of a small business for accounting rules would simplify tax administration and taxpayer compliance. Accordingly, the administration proposes to create a uniform threshold of $25 million in average annual receipts for allowing exceptions to certain accounting rules. Businesses below the threshold could elect one of the following more simplified accounting methods:

* The cash method in lieu of the accrual method;
* The non-application of the uniform capitalization rules; or
* The use of an inventory method of accounting that conforms to the taxpayer’s financial accounting method or otherwise properly reflects income.

The $25 million threshold would be indexed for inflation, and average annual receipts would be determined over a three-year period. Further, entities treated as a single employer under existing law would be treated as a single entity for purposes of this exception. Businesses that exceed the threshold would not be allowed to make an election to use the simplified accounting methods for the current taxable year and four years thereafter.

The Greenbook says these rules would not revoke current exceptions that allow the cash method by personal service corporations and business entities that are not C corporations, regardless of size. The proposal would be effective for taxable years beginning in 2016 and would lose $14.7 billion in revenue over 10 years.

Tax-exempt bonds

As part of its focus on infrastructure, the budget adds several provisions that address tax-exempt and private activity bonds.

**Qualified Public Infrastructure Bonds**: The administration says that existing rules for tax-exempt bonds limit the involvement of the private sector in public infrastructure projects and therefore proposes establishing a hybrid category of tax-exempt bonds called Qualified Public Infrastructure Bonds (QPIBs).

QPIBs would be eligible to finance specific infrastructure projects, such as airports, docks and wharves, mass transit, water supply facilities, sewage or solid waste disposal facilities, and highway or surface freight transfer projects. Projects would have to be owned by a state or local government and would have to meet a public use requirement. QPIBs would not be subject to the bond volume cap requirement, and the alternative minimum tax preference for interest on private activity bonds would not apply.

The proposal would be effective for bonds issued in 2016 or later and would lose $4.8 billion over 10 years.

**Bank investment in tax-exempt bonds**: Under current law, financial institutions cannot deduct any interest expense allocable to tax-exempt obligations, but there is an exception that allows them to deduct 80 percent of their interest expense for certain qualified tax-exempt obligations. These qualified obligations are issued by states and local governments that issued no more than $10 million in certain tax-exempt bonds annually (the qualified small issuer limit).

The administration believes that the current rules deter financial institutions from investing in tax-exempt debt and notes that banks invested more in tax-exempt bonds when the rules were temporarily loosened in 2009 and 2010 under the American Recovery and Reinvestment Act (ARRA).

Accordingly, the administration proposes raising the qualified small issuer limit to $30 million. In addition, the proposal would permanently implement an ARRA provision that allowed financial institutions to deduct 80 percent of interest expense allocable to any tax-exempt bond. This exception would be limited to 2 percent of the financial institution’s assets; however, the 2 percent limit would not apply to qualified tax-exempt obligations.

The proposal would be effective for bonds issued beginning in 2016 and would lose $3.4 billion over 10 years.

**Tax-exempt bond financing of professional sports facilities**: The Greenbook notes that while professional sports facilities are not one of the permitted categories for qualified private activity bonds, such facilities can still be financed with tax-exempt government bonds if the debt service is paid from certain sources other than private payments, such as generally applicable taxes (the private payments test). The administration believes the current rules result in artificial financing structures, issuance of excessive tax-exempt debt, and shifting the cost and risks of the facilities from the private owners to taxpayers.

The administration, therefore, proposes to eliminate the private payments test for professional sports facilities, making bonds to finance these facilities taxable private activity bonds if more than 10 percent of the facility is used for private business use.

The proposal would be effective for bonds issued beginning in 2016 and would raise $542 million by 2025.

Returning business revenue provisions

Some notable business offsets carried over from previous budget packages include proposals to:

* Repeal the nonqualified preferred stock designation, and eliminate the “boot-within-gain” limitation under section 356(a);
* Repeal the last in, first out (LIFO) and lower of cost or market (LCM) accounting methods;
* Slow the depreciation schedule for corporate jets; and
* Treat individual owners of professional service businesses organized as S corporations, limited partnerships, general partnerships, and LLCs taxed as partnerships would all be treated as subject to SECA taxes in the same manner and to the same degree.

Limited ‘extenders’ included

The president’s budget blueprint does not explicitly include an “extenders” package to address the several dozen temporary tax deductions, credits, and exclusions that expired at the end of 2014; however, it does propose to renew or make permanent a number of these expired provisions. Most notably, the budget proposal would:

* Permanently extend the subpart F exception for active financing income and the lookthrough treatment of payments between related controlled foreign corporations. (This is new in this year’s budget proposal. Past budgets called for a temporary extension).
* Expand and permanently extend the research and experimentation credit.
* Modify and permanently extend the renewable energy production tax credit and investment tax credit.
* Modify and permanently extend the New Markets Tax Credit and the Work Opportunity Tax credit.
* Modify and extend the tax credit for the construction of energy-efficient new homes.
* Modify and permanently extend the deduction for energy-efficient commercial building property.
* Permanently extend the increased section 179 expensing and investment limitations.
* Modify and extend the tax credit for cellulosic biofuels.
* Enhance and make permanent (with modifications) the deduction for contributions of conservation easements.
* Extend the exclusion from income for cancellation of certain home mortgage debt.

GOP reaction

Republican congressional leaders generally have been dismissive of many of the proposals in the White House budget blueprint in the days since its release; but the chairs of the House and Senate taxwriting committees acknowledged that they see potential opportunities to work with the Obama administration on certain issues related to tax reform.

At a February 3 House Ways and Means Committee hearing, Chairman Paul Ryan, R-Wis., criticized the proposal as “another call for higher taxes” and told Treasury Secretary Jack Lew (the sole witness at the hearing) that “[w]e are not raising taxes on the American people. They’re working harder than ever to get ahead. And they deserve a break, not another tax hike.”

Ryan noted, however, that the administration has “gradually, grudgingly taken a few steps in the right direction” on business tax reform and “is taking a few more baby steps in our direction by proposing a few ways to simplify the tax code for middle-class families.”

Senate Finance Committee Chairman Orrin Hatch, R-Utah, speaking at a February 5 hearing, likewise cited a litany of “shortcomings” in the budget package such as “higher taxes that would stifle job creation, economic growth, savings, and investment; new wealth taxes; muddled thinking about distributional issues; a lack of significant reforms to our unsustainable entitlements; ongoing deficits and outsized, risky federal debt; and a repackaged bank tax that nods to the ineffectiveness of the Dodd-Frank law.” But he told Treasury Secretary Lew that Republicans and the administration “share a desire to reform our tax code, which everyone agrees is severely broken, does not help American families, and harms American businesses.” Hatch added that tax reform would have to address “businesses of all types, not just one particular organizational form.”

Observations

The president’s budget proposal raises a number of significant issues for taxpayers and policymakers as the tax-and-spending debate moves forward.

**Blueprint, opening offer, or unrealized vision?:** The budget tells us where the president wants to take the country; but Congress is now controlled by the Republicans – who have very different ideas about taxes and spending and are unlikely to regard this document as the starting point for negotiations. Indeed, several leading congressional Republicans have already declared many of the proposals to be dead on arrival. That being the case, the question becomes whether the budget is better described as (1) the administration’s opening offer to Republicansin a longer-term bid to find to middle ground – especially on tax reform, where some common ground does appear to exist, or (2) an aspirational document, more suitable for campaign speeches and setting the political narrative for 2016 than as the basis for further negotiations.

**Can it propel tax reform?:** Although the budget as a whole is a nonstarter for Congress, the president’s call for rate-reducing ***corporate*** tax reform (a 28 percent headline rate, reduced to 25 percent for manufacturing) is consistent with the desires of congressional Republicans to lower the corporate rate (although their stated target is 25 percent).

But the president’s proposal does not provide similar rate reduction for passthroughs, which account for a very large share of business income in the United States. The GOP has called for comprehensive reform in the past but appears willing to explore the idea of business-only tax changes that address both C corps and passthroughs. To that extent, the president’s embrace of a territorial tax regime, albeit with safeguards to prevent base erosion (i.e., the 19 percent minimum tax rate, which many businesses will find to be unacceptably high), may help clear the way for the two parties to better determine if there is sufficient common ground to make legislating possible during the very narrow window in 2015 before presidential politics becomes the dominant factor in policy debates.

And that leads to a very important caveat for individuals and businesses. Proposals that, on their own, seem impossible in the current political environment – for example, the proposed high tax rate for deemed repatriation of offshore earnings, limits on charitable deductions, changes to the taxation of certain financial instruments, or repeal of the LIFO method of accounting – can become, in the context of broader tax reform,more probable.

**Borrowed from the GOP but with important changes:** In many cases, the budget purports to be consistent with ideas put forward by Republicans in the past. On more than one occasion in recent weeks the administration has noted that there is significant overlap between the proposals in the president’s corporate tax reform framework and those in former Ways and Means Chairman Camp’s tax reform proposal from last year. It’s worth noting, however, that Camp often cautioned that these proposals were only to be taken up as part of a comprehensive rate-lowering, base broadening tax reform effort. Moreover, while the White House proposals share some nominal similarities with the Camp plan, they often include specific differences that may make them unpalatable to current legislators:

* **Deemed repatriation –** The Camp proposal called for deemed repatriation of foreign profits, but that proposal came with much lower rates (3.5 percent related to investments in hard assets and 8.75 percent for cash and cash equivalents) than the flat 14 percent rate proposed in the president’s budget. The Camp draft also would have given companies more time to pay those taxes than the five-year window spelled out in President Obama’s fiscal year 2016 budget submission.
* **Bank tax –** The Camp proposal included a bank tax, which was limited to so-called systemically important financial institutions (SIFI). The president’s proposal appears to hit far more institutions and raises far more money than its counterpart in the Camp draft.
* **Capital gains rate –** The top capital gains rate after President Reagan succeeded in passing tax reform in 1986 was 28 percent. But the administration’s suggestion that raising the current-law top capital gains rate to 28 percent would simply return it to its Reagan-era level misses the fact that in 1986 the top marginal rate on ordinary income was much lower than it is today.

**Middle-class economics = higher taxes on the wealthy:** In the forward to the budget document he sent to Congress, the president writes that his tax-and-spending blueprint was designed to “bring **middle-class economics** into the 21st Century” (emphasis added). But many upper-income taxpayers, who face the prospect of an increase in the top tax rate on capital gains, a reduction in the value of expenditures, the imposition of the Buffett rule, and taxation of carried interest as ordinary income, may take issue with the president’s characterization of his budget package.

**Are we closer to resolving the long-term highway financing shortfall?:** The administration’s budget calls for the bulk of the estimated “one-time” revenues from the proposed minimum repatriation tax – $238 billion – to be set aside to fund infrastructure spending. Given that the Highway Trust Fund’s current authorization expires May 31 and the fund will become insolvent soon thereafter unless Congress approves a new authorization and provides an additional source of revenue, it appears doubtful that the president’s proposal could be enacted in time to address the current funding dilemma. The gulf between the White House and the GOP on tax reform issues would appear to preclude the possibility of passing tax reform legislation with a repatriation provision on such a tight timeline; moreover, Republican leaders, citing a JCT study showing that stand-alone voluntary repatriation proposals lose revenue over the long term, are unlikely to consider a repatriation plan outside the scope of fundamental tax reform.

**Long-term fiscal challenges remain:** The president’s budget proposal calls for stabilizing debt and deficits; but over the long term these will continue to rise as a result of several factors, especially the rising cost of medical care, an aging population, and higher debt service costs. This budget leaves many of those most difficult challenges – especially questions facing future financing of Social Security and Medicare – to a future year.

This summary was prepared by the Tax Policy Group.

**Contact**

Jeff Kummer

Director of Tax Policy

Deloitte Tax LLP

jkummer@deloitte.com

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