Tax Briefing

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Fiscal Year (FY) 2017 Budget Proposals

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Special Report

HIGHLIGHTS

- Modifications Within NII Tax And SECA Tax
- New Oil Fee For Infrastructure/Clean Energy
- Revisions To ACA's "Cadillac Tax"
- New Community College Partnership Tax Credit
- Retirement Savings Reforms
- Small Business Tax Reform And Simplification
- Increased Funding For IRS
- Enhancements To Tax Administration

INSIDE

Obama Lays Out Tax Plans In Final Budget

President Obama called for expanding middle-income tax incentives, tweaking the Affordable Care Act's excise tax on high dollar health plans and net investment income (NII) tax, imposing a fee on oil to fund infrastructure spending, and more in his fiscal year (FY) 2017 federal government budget released on February 9. This is the final federal budget that President Obama will propose. As expected, the President also renewed tax proposals from previous budgets, particularly in the international and retirement savings areas. The overall White House budget would raise over $2.8 trillion in revenue over the next 10 years.

IMPACT. *Although many in the GOP-controlled Congress have labeled the FY 2017 budget as a "non-starter," some proposals may be enacted before the President leaves office. In past years, certain individual proposals in the President's budget have moved through Congress either as individual pieces of legislation or as attachments to other bills. During 2015, 17 proposals within the administration's FY 2016 revenue proposals found their way into enacted legislation. Comprehensive tax reform, however, appears to be on hold until after the November elections.*

IMPACT. *The Protecting Americans from Tax Hikes Act of 2015 (PATH Act) made permanent many of the so-called tax extenders, and are no longer part of the administration's proposals. However, the administration has proposed enhancements to some of these popular tax breaks.*

COMMENT. *At a press briefing coordinated with the release of the "General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals" (the "Greenbook"), a senior Treasury official commented that of the individual revenue proposals in this year's budget, six are entirely new, 9 reflect certain policy changes, 15 have been modified or combined from proposals made for FY 2016, and 115 are substantially the same from last year.*

NEW PROPOSALS

The administration may have a special interest in promoting proposals entirely new within its FY 2017 budget, in contrast to those being seen again from past years. As a result, the following provisions deserve special note. Several of these provisions may also appear in stand-alone legislation, either to promote infrastructure projects, education initiatives or retirement savings options, for example, or to fund other tax proposals that may be introduced in Congress during the rest of 2016.

Plugging Gaps within NII and SECA Taxes. A new proposal attempts to bring more consistency in the application of the net investment income (NII) tax and the Self-Employed Contributions Act (SECA) tax, especially among higher income taxpayers and owners of professional service businesses. In particular, current law treats active owners of pass-through businesses differently according to the legal form of their ownership and the legal form of the payment that they receive. This difference affords some owners more favorable tax treatment solely based on the type of entity in which they have an ownership stake or the form of payment that they receive.

IMPACT. *The NII tax on investment income is set at 3.8 percent for high-income taxpayers; while the SECA tax on labor also totals 3.8 percent (a 2.9 percent rate for Medicare on all employment earnings and a 0.9 percent rate imposed on wages and self-employment earning of high-income taxpayers). The proposal would ensure that the 3.8 percent is paid by amending the definition of net investment income to include gross income and gain from any trades or businesses of an individual that are not otherwise subject to employment taxes.*

New Oil Fee to Fund Infrastructure Investments. The administration wants to impose a fee on a per barrel equivalent of crude oil for all petroleum products, whether imported or domestically produced (but not exported). A fee of $10.25 per barrel (adjusted for inflation from 2016) would be phased in over a five-year period. Considered a win-win by the administration, fees would help lower carbon emissions in addition to being used to increase investment in a more efficient and cleaner transportation infrastructure.

COMMENT. *House Majority Leader Kevin McCarthy, R-Calif., said that House Republicans will not take up the President's proposal to impose a fee on oil.*

COMMENT. *President Obama also proposed, as in past budgets, to eliminate tax preferences for fossil fuels, including the credit for oil and gas produced from marginal wells and special expensing rules for intangible drilling costs.*

Improvement to the ACA's "Cadillac Tax." The administration proposes changes that would ensure that the excise tax on high cost employer-sponsored health plans (the so-called "Cadillac tax"), which was postponed but not repealed by the PATH Act, would only apply to the highest-cost plans. The proposal mandates that the tax threshold be increased to the greater of the current law threshold or a "gold plan average premium" calculated and published for each state. In so doing. it would modify the threshold to reflect regional differences.

COMMENT. *As explained in the Greenbook, "the State average gold plan premium would be a weighted average of the premiums for the lowest-cost silver self-only Marketplace plans offered for each age and county in the state, multiplied by 8/7 to simulate the cost of an actuarially-equivalent gold plan."*

COMMENT. *Although this concession to improve this controversial tax may gain bipartisan support, there is significant support in both parties to repeal rather than modify the tax.*

> "The administration may have a special interest in promoting proposals entirely new within its FY 2017 budget in contrast to those being seen again from past years."

New Community College Partnership Tax Credit. The administration proposes that qualifying employers that hire graduates from community and technical colleges receive a one-time credit of $5,000 for each qualifying employee hired on a full-time, permanent basis. Funding would be by way of a $500 million tax credit authority for each of the five years, 2017 through 2021.

COMMENT. *The credit, explained as a component of the general business credit, would be used as an incentive to encourage employer engagement and investment in community and technical college education.*

Single Multiple-Employer DB Plan for Unaffiliated Employers. This proposal would allow unaffiliated employers to establish and maintain a multi-employer contribution plan that would then be treated as a single plan for purposes of ERISA.

IMPACT. *The change would make it both easier and less cost prohibitive for small employers to offer tax-qualified retirement benefits to their employees.*

Collection of Child Support Payments. The administration proposes greater disclosure and other amendments to facilitate the collection of child support payments.

REVENUE RAISING PROVISIONS

Proposals that would raise revenues are sometimes used to jump start a compromise on legislation that may provide a benefits/spending component. Revenue proposals in the administration's FY 2017 budget, however, will nevertheless continue to run up against those members of Congress who are committed to not raising taxes under any circumstances. Proposals within the general revenue-raisers category, not discussed elsewhere in this Briefing, include:

- Increasing the long-term capital gains and qualified dividends tax rate from 20 percent to 24.2 percent, principally for taxpayers now subject to the 3.8 percent net investment income tax rate, for a combined top rate on investment income of 28 percent
- Reinstating the 2009 estate and gift tax rates and exclusions, with a top rate of 45 percent, and an exclusion of $3.5 million for estates, $1 million for gifts (in contrast to the 2016 rate of 40 percent on estates greater than $5.45 million);
- Expanding the property subject to the basis/valuation consistency requirement that was enacted in 2015 to include property qualifying for the estate tax marital deduction where a return is filed and property transferred by gift where the gift is required to be reported on a federal gift tax return;

- Modifying transfer tax rules for grantor retained annuity trusts and other grantor trusts;
- Adopting the "Buffett Rule" of taxing higher-income taxpayers with large deductions and other tax preferences at a minimum 30-percent rate;
- Capping the value of certain tax expenditures, including charitable deductions, at 28 percent;
- Taxing carried interest, typically received by hedge fund and private equity fund managers, at ordinary rates, rather than as capital gain, as well as being subject to self-employment taxes; and
- Limiting the gain-deferral benefits of Sec 1031 like-kind exchange treatment to $1 million per taxpayer per tax year for real estate deals.

INTERNATIONAL PROPOSALS

The administration's FY 2017 provisions generally track the international recommendations made a year ago, with some revised revenue estimates and removal of certain Subpart F active financing and controlled foreign corporation proposals that were enacted in 2015. FY 2017 proposals would:

- Impose a 19-percent minimum tax on foreign income;
- Impose a 14-percent one-time tax on previously untaxed foreign income;
- Restrict corporate inversions by limiting the ability of U.S. corporations to expatriate by broadening the definition of an inversion;
- Provide tax incentives for locating business activity in the U.S. and remove tax deductions for shipping jobs overseas;
- Limit the shifting of income through intangible property transfers;
- Restrict the use of hybrid arrangements that create stateless income; and
- Restrict deductions for excess interest of members of financial reporting groups.

IMPACT. *Most observers see international tax reform as a discrete area that may be tackled independently of either general business or individual tax reform. Although anti-inversion and similar "quick-fix" provisions may see some light of day before the presidential elections, consensus is that international reform – including consideration of the proposals within the Obama administration's FY 2017—likely will form the first major tax out of the gate in 2017.*

COMMENT. *"Everyone who looks at our business tax system would say that it needs to be fixed and part of doing that is to address the multinational side of things," a senior Treasury official commented upon release of the FY 2017 budget. The official also observed that the anti-corporate inversion provision could easily find its way into separate legislation.*

SMALL BUSINESS TAX RELIEF/SIMPLIFICATION

The PATH Act made permanent enhanced small business expensing under Code Sec. 179. The administration would increase the annual expensing limitation from $500,000 to $1 million (while the phase-out threshold would remain at the inflation-adjusted $2 million level). The $25,000 limit on expensing of sport utility vehicles would also be indexed for inflation.

Other proposed tax relief for small businesses includes:

- Expanding simplified accounting through a uniform small business threshold at $25 million (indexed for inflation) in average annual gross receipts for allowing exceptions from certain accounting rules;
- Increasing and consolidating the deduction for start-up and organizational expenditures up to $20,000 (with a $120,000 expenditure limit); and
- Expanding and simplifying the Code Sec. 45R credit to qualified small employers for non-elective contributions to employee health insurance.

IMPACT. *The Affordable Care Act's Code Sec. 45R credit would expand to include employers with up to 50, rather than 25, full-time equivalent (FTE) employees, with phase out between 20 and 50, rather than 10 and 25, FTEs.*

WHAT'S NEW IN THE ADMINISTRATION'S 2017 BUDGET?

President Obama's fiscal year (FY) 2017 budget contains approximately 145 separate proposals, 6 of which are new, 15 are modified or combined from FY 2016 proposals, 9 reflect certain policy changes, and 115 are substantially the same as proposals issued for FY 2016. Seventeen proposals from the administration's FY 2016 budget proposals were enacted during 2015 and, therefore, are no longer included.

Highlights of the new proposals include:

- Plugging gaps within coverage between NII and SECA taxes
- Phasing in a new, $10.25/barrel oil fee for infrastructure /clean energy
- Modifying the ACA's "Cadillac tax" to better target the highest-cost plans
- Introducing a community college partnership tax credit for employers
- Allowing unaffiliated employers to join in a single multiple-employer defined contribution plan
- Facilitating the collection of child support payments

COMMENT. *Comprehensive tax reform, both at the individual and business levels, likely will not be sorted out until after the 2016 Presidential Elections. Nevertheless, certain FY 2017 budget proposals may see action beforehand, either in use to fund certain, "one-off" tax breaks, or to address certain controversial strategies, such as corporate inversions.*

INDIVIDUALS

The tax-expenditure side of the administration's proposals for middle-class tax relief focuses primarily on child care, education and two-earner couples, including provisions to:

- Provide a second-earner tax credit for two-earner families;
- Reform child care tax incentives by repealing dependent care flexible spending accounts, increasing the child and dependent care credit and providing a larger credit for taxpayers with children under age five;
- Simplify and target education tax benefits to improve college affordability by expanding availability of the American Opportunity Tax Credit (AOTC) among other changes;
- Expand the earned income tax credit (EITC) for workers without qualifying children; and
- Extend the exclusion from income for the cancellation of qualified principal residence mortgage debt through 2017.

COMMENT. *House Speaker Paul Ryan, R-Wisc., has expressed interest in revisiting programs targeted to poverty eradication and the EITC is one area where the administration and the House GOP may reach common ground.*

COMMENT. *Unlike last year's proposals on education incentives, the administration makes no mention of repealing Coverdell ESAs or reducing the federal tax benefits of qualified tuition programs to offset the cost of the expanded benefits proposed.*

CHARITABLE PROVISIONS

President Obama proposed to reform the rules for conservation easement deductions, including piloting a non-refundable credit for conservation easement contributions as an alternative to the deduction. The President also proposed to increase the standard mileage rate for automobile use by volunteers.

RETIREMENT PROVISIONS

Coming up with better ways to save for retirement has been a theme over the past years common to both Congressional hearings and administration efforts. The administration's FY 2017 budget includes proposals that would:

- Require employers in business for at least two years and having more than 10 employees and offering no retirement plan to offer an automatic payroll-deduction IRA option;
- Expand the exemption from the 10-percent penalty for early withdrawal from retirement savings to include long-term unemployed individuals (more than 26 weeks), subject to certain limits;
- Require Code Sec. 401(k) plans to expand eligibility to include employees who have worked at least 500 hours each year with the employer for at least three consecutive years;
- Permit rollovers to facilitate annuity portability; and
- Simplify required minimum distribution (RMD) rules.

COMMENT. *The automatic payroll IRA option proposal also adds a tax credit of up to $4,500 to employers with 100 or fewer employees as an incentive to offer this plan; as well as a $1,500 incentive paid over three years to employers that already have a retirement plan.*

COMMENT. *On the loophole-closing side of retirement planning, the administration proposes to permit amounts in a traditional IRA to be converted to a Roth IRA only to the extent a distribution of those amounts would be includable in income if they were not rolled over. For example, after-tax amounts (attributable to basis) held in a traditional IRA could not be converted to Roth amounts. As a result, the proposal would put an end to a strategy under which some taxpayers, who are not eligible to make contributions to a Roth IRA because their modified AGI exceeds regular limits, are able to indirectly make contributions to a Roth IRA by making nondeductible contributions to a traditional IRA and then converting the traditional IRA to a Roth IRA.*

Also characterized as a "loophole closer," the administration would limit the total accrual of tax-favored retirement benefits. Generally, it would limit accumulated amounts in tax-favored retirement plans to an amount necessary to provide an annuity currently at approximately $210,000 per year. The proposal would be effective for contributions and accruals for tax years after 2016.

GENERAL BUSINESS PROVISIONS

Most business proposals in the administration's FY 2017 budget mirror those introduced several years ago. Many continue to have the support of Republican members of Congress, but as provisions that would be included in a more comprehensive tax package. These proposals include:

- Repeal of the last-in, first-out (LIFO) method of accounting;
- Enhanced and simplified research incentives beyond changes made by the PATH Act;
- Addition of tax incentives for designated Promise Zones; and
- Additional tax credits for investments in qualified property used in a qualifying advanced energy manufacturing project.

COMMENT. *An employment tax credit, applicable to the first $15,000 of annual qualifying zone employee wages, would be provided to businesses that employ Promise Zone residents. The credit rate would be 20 percent for zone residents who are employed within the zone and 10 percent for zone residents employed outside of the zone. Additionally, qualified property placed in service within the zone would* *be eligible for additional first-year depreciation of 100 percent of the adjusted basis of the property.*

IMPACT. *Absent from the FY 2017 budget is a proposal to broadened the corporate tax base in exchange for reducing the corporate rate to 28 percent, with a 25 percent effective rate for domestic manufacturing. The FY 2016 budget had included rate reduction as part of comprehensive business tax reform, which likely will not take place until the next administration is in place.*

ENERGY PROVISIONS

President Obama has proposed to modify and permanently extend the renewable electricity production tax credit. Other energy-related proposals include:

- Modifying and extending the credit for the construction of energy-efficient new homes;
- Modifying and permanently extending the deduction for energy-efficient commercial building property;
- Providing a carbon dioxide investment and sequestration tax credit; and
- Replacing the credit for plug-in electric drive motor vehicles with a credit for advanced technology vehicles.

COMMENT. *The renewable electricity production tax credit for wind facilities is currently available through 2019; however, the credit phases out beginning in 2017.*

IRS BUDGET/TAX ADMINISTRATION

President Obama has asked Congress to fund the IRS at $11.8 billion (in base discretionary resources) for FY 2017. The President's proposed level of funding would represent an increase of $530 million (4.7 percent) compared to FY 2016.

COMMENT. *The IRS was criticized by many lawmakers for its low levels of customer service during the 2015 filing season. Congress appropriated an additional $290 million for FY 2016 to improve customer service and cybersecurity and to curb tax-related identity theft. The President said that with the additional funds in his FY 2017 budget, the IRS will increase staffing for traditional taxpayer services, bolster defenses against stolen identify refund fraud, and provide assistance to taxpayers who call the IRS for assistance.*

President Obama also revived some previous proposals related to the IRS and tax administration, among them, proposals to:

- Provide the IRS with greater flexibility to address correctable errors;
- Give tax whistleblowers more protections;
- Enhance penalties for tax-related identity theft; and
- Authorize the IRS to regulate unenrolled preparers.

COMMENT. *The IRS's Registered Tax Return Preparer (RTRP) program was struck down by a federal appeals court as exceeding the agency's statutory authority in Loving, CA D.C., 2014-1 USTC ¶50,175.*

SELECTED REVENUE RAISERS

Top revenue raisers in the FY 2017 budget (based on Greenbook estimates) include:*

Limit value of certain individual tax deductions/benefits to 28 percent	$645 billion
19 percent minimum tax on foreign income	$350 billion
Imposition of per barrel oil fee	$319 billion
Preventing avoidance of NII and SECA taxes	$271 billion
Estate/gift tax rollback to 2009	$201 billion

*Over 10 years