President Obama’s FY 2017 Budget Builds on Previous Tax Proposals

President Obama’s FY 2017 Budget released today (February 9, 2016) continues to call for business tax reform that would impose a 19% minimum tax on the foreign earnings of US-based multinational corporations and a 14% one-time tax on previously untaxed foreign income, which would provide revenue under a transportation investment plan that includes a new $10.25 per barrel fee on oil that would be paid by oil companies. The oil fee is one of only a handful of new provisions in the Budget, which also include an expansion of the 3.8% net investment income tax to more of the business income of high-income taxpayers. The Budget also continues to emphasize provisions intended to “prevent US companies from avoiding tax through ‘inversions’” and from “using excessive interest deductions to ‘strip’ earnings out of the United States.”

The 21st Century Clean Transportation Plan “continues the President’s call to utilize one-time revenues from business tax reform to provide a temporary near-term surge in investment to set us on the right path for the years ahead,” while the new oil fee “raises the funding to make the new investments we need while also providing for the long-term solvency of the Highway Trust Fund to ensure we maintain the infrastructure we have.” Under the plan, the oil fee would raise $319 billion over 10 years and transition revenue from business tax reform would raise $176 billion over 10 years, to fund $495 billion in transportation investment.

Like last year’s version, the FY 2017 Budget proposes to increase the top capital gains and dividend tax rate to 28% increasing the rate from 20% to 24.2% plus the 3.8% net investment income tax. Last year’s Budget included a provision to treat individual owners of professional service businesses organized as S corporations, limited partnerships, general partnerships, and LLCs taxed as partnerships, all as subject to Self-Employment Contributions Act (SECA) taxes in the same manner and to the same degree. The FY 2017 Budget would expand upon that proposal, amending 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 Treasury Department said the change is intended to address the limited partners and members of LLCs or other entities taxed as partnerships who materially participate in their firms but who claim the limited partner exclusion from SECA. The total proposal would raise $272 billion over 10 years.

The FY 2017 Budget alters the 40% tax on high-cost health plans, also called the “Cadillac Tax.” The Administration’s proposal revises the tax by attempting to adjust for geographic variations. The proposal would change the threshold so the tax does not exceed the average cost of a “gold” level exchange plan in the state. The proposal also calls for a study on the impact of the tax on critically ill workers. The effective date of the tax was delayed by two years in legislation enacted at the end of 2015, and is now slated to start in 2020. This proposal is estimated to cost $1.26 billion over 10 years.
President Obama’s eighth and final budget was released amid limited expectations for bipartisan legislative achievements during an election year featuring a heated presidential race and potential change in control of the Senate given that a lopsided number of Republican seats are up for re-election. Republicans in Congress have reacted particularly coolly to the President’s Budget even prior to its release. Reacting to the new oil fee proposal last week, Speaker Paul Ryan (R-WI) said, “As this lame-duck president knows, it’s dead on arrival in Congress, because House Republicans are committed to affordable American energy and a strong U.S. economy.”

Additionally, Senate Budget Committee Chairman Mike Enzi (R-WY) and House Budget Committee Chairman Tom Price (R-GA) have broken with tradition and are not inviting Office of Management and Budget Director Shaun Donovan to testify regarding the Budget. “Rather than spend time on a proposal that, if anything like this Administration’s previous budgets, will double down on the same failed policies that have led to the worst economic recovery in modern times, Congress should continue our work on building a budget that balances and that will foster a healthy economy,” they said in a joint statement.

The Budget’s release also comes on the heels of a flurry of bipartisan legislating in the latter part of 2015, including the Protecting Americans from Tax Hikes (PATH) Act package enacted with the Consolidated Appropriations Act of 2016 that made a number of tax extenders provisions permanent and extended others for periods of five and two years. The FY 2017 Budget is similar to the Budget released last year, aside from the PATH Act provisions that have been enacted in the interim.

Like the other Budgets of recent years, tax proposals in the FY 2017 version are presented in two categories: “elements of business tax reform” (previously called a “reserve for business tax reform that is revenue neutral in the long run”) that combines revenue-raising provisions with incentives that cost money; and budget proposals outside of the context of reform. The main budget document references the February 2012 President’s Framework for Business Tax Reform, which proposed to cut the statutory corporate income tax rate to 28% with a 25%effective rate for domestic manufacturing. Like the Framework, the FY 2017 Budget does not provide a complete picture of how those rate reductions would be achieved. The “elements of business tax reform” section is estimated to raise $550 billion over 10 years and the 14%minimum tax an additional $300 billion, though at least $176 billion is to be dedicated to transportation investment.

The Treasury Greenbook accompanying the FY 2017 repeats essentially the same five goals as the 2012 Framework: (1) cut the corporate tax rate and pay for it by making structural reforms and eliminating loopholes and subsidies; (2) strengthen American manufacturing and innovation; (3) strengthen the international tax system; (4) simplify and cut taxes for small businesses; and (5) avoid adding to deficits in the short-term or the long-term.

INTERNATIONAL TAX

The international tax portion of the Budget is essentially the same as in last year’s Budget. Because the active financing exception under Subpart F was made permanent under the 2015
year-end legislation, it is not included. However, the Budget does make permanent the CFC look-through rule, which was only extended for five years as part of the tax extenders bill.

The 19% minimum tax is part of a reform of the international tax rules that would repeal the current system of tax deferral for undistributed non-subpart F income of foreign subsidiaries of US corporations, for years after 2016. The mechanism is identical to the version in last year’s budget. This year’s proposal is estimated to raise $350 billion over 10 years, considerably more than the $206 billion 10-year estimate from last year.

Other Subpart F changes under the Budget include eliminating the requirement that a US shareholder own a CFC’s stock for an uninterrupted period of at least 30 days in order for subpart F income of the CFC to be taxable to the US shareholder. In addition, the ownership attribution rules of section 958(b) would be amended to allow downward attribution of stock ownership in a target foreign corporation from a foreign corporate shareholder to its US subsidiary for the purpose of determining whether the target foreign corporation is a CFC. Also included are the expansion of subpart F income to cover certain income from digital goods and services and income from the sale of property manufactured for the CFC by a related service provider.

The Budget again proposes allowing a US multinational corporation to elect the worldwide interest allocation method for taxable years beginning after 2016. Under current law, the election is not available until taxable years after December 31, 2020.

Two proposals would limit the ability to use hybrid entities and arrangements in cross-border tax planning. One proposal would deny deductions for interest or royalty payments to related parties in circumstances involving hybrid arrangements. A hybrid arrangement would exist if the payment was not includible in a foreign recipient's taxable income, or if the US taxpayer were able to claim a deduction for the same payment in a foreign country. The second proposal would prevent the application of the so-called same-country exception of section 954(c)(3) and the CFC look-through rule of section 954(c)(6) to payments received by a foreign reverse hybrid entity owned by a US person when such payments are deductible expenses of a related foreign person.

Like last year’s version, the Budget proposal to expand the scope of the anti-inversion statute would make two significant changes to section 7874. First, it would reduce the existing 80% test of shareholder continuity to a 50% test, while eliminating the existing 60% test and provisions related to the 60% test. Second, the proposal would add a special rule providing for an acquiring foreign corporation to be treated as a domestic corporation for US tax purposes, regardless of shareholder continuity, if (1) the foreign corporation is primarily managed and controlled in the United States, (2) immediately before the acquisition, the market value of the US target’s stock was greater than the market value of the foreign corporation’s stock, and (3) the worldwide group that includes the foreign corporation does not have substantial business activities in the foreign corporation’s country of incorporation.
The proposal to modify tax rules for dual capacity taxpayers would tighten the foreign tax credit rules applicable to taxpayers subject to a foreign levy that receive a specific economic benefit from the levying country.

The proposal to disallow deductions for non-taxed reinsurance premiums paid to affiliates would: (1) deny an insurance company a deduction for premiums (and other amounts) paid to affiliated foreign companies to the extent that the foreign reinsurer (or its parent company) is not subject to US income tax with respect to the premiums received; and (2) would exclude from the insurance company's income any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A general tax credit for relocating a trade or business into the US and denial of deductions for the cost of outsourcing a US trade or business would be made available, equal to 20% of eligible expenses connected with “insourcing” a trade or business from a foreign location to the United States. Conversely, deductions would not be available for expenses connected with “outsourcing” a US trade or business to a foreign location.

The Budget again re-proposes preventing “inappropriate shifting of income outside the United States” by clarifying the definition of intangible property for purposes of section 367(d) and 482 to include workforce in place, goodwill and going concern value and to enhance the IRS’s authority to value intangible property.

SMALL BUSINESSES

The Budget's proposals for small business simplification and tax relief are essentially the same as in recent years, calling for an increase in the Section 179 small business expensing limit to $1 million beginning after December 31, 2016. The Budget also includes a proposal to create a uniform small business threshold at $25 million in average annual gross receipts below which businesses could use the cash method of accounting in lieu of an accrual method, and other simplified accounting methods.

R&D

While the R&D Credit was made permanent by the year-end 2015 tax legislation, the Budget continues to propose: increasing the rate of the alternative simplified credit (ASC) from 14% to 18% eliminating the reduced ASC rate of 6% for businesses without qualified research expenses in the prior three years; allowing 75% of contract research expenses if paid to qualified non-profit organizations (such as educational institutions) for qualified research; and allowing the R&D Credit to offset AMT liability for all taxpayers. The Budget also proposes repealing the requirement that research and experimentation expenditures be amortized over 10 years for purposes of the individual AMT.

FINANCIAL SERVICES
The financial services portion of the “elements of business tax reform” section includes the same set of provisions from last year’s Budget:

- require that derivative contracts be marked to market with resulting gain or loss treated as ordinary;
- 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 TINs, and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller;
- modify proration rules for life insurance company general and separate accounts;
- expand pro rata interest expense disallowance for corporate-owned life insurance; and
- change the net operating loss (NOL) carryover rules for life insurance so NOLs would be carried back up to two taxable years prior to the loss year, and carried forward 20 taxable years following the loss year, similar to carryover rules for other companies.

Beyond the “elements of business tax reform” category, the Budget again proposes a 7-basis point fee that would apply to banks, bank holding companies, and “non-banks,” including insurance companies, savings and loan holding companies, exchanges, asset managers, broker dealers, “specialty finance corporations,” and finance captives, unless their worldwide financial assets are less than $50 billion. US subsidiaries and branches of foreign entities would be subject to the tax. The tax would apply to “covered liabilities,” which are assets less equity for banks and nonbanks, with a deduction for separate accounts, mainly for insurance companies. Like the proposal in prior years, the tax would be deductible, and would be effective after December 31, 2016. The financial fee would raise $111 billion over 10 years, the same as last year’s proposal.

INCENTIVES FOR REGIONAL GROWTH

The “regional growth” proposals in the FY 2017 Budget are substantially similar to the proposals in the FY 2016 budget with some minor changes. Most significantly, the Budget once again calls for making the New Markets Tax Credit program permanent, and exempting the credit from the alternative minimum tax. The New Markets Tax Credit was extended for five years in the 2015 year-end tax legislation. It also proposes to permit states to trade-in up to 18% of their private activity bond cap authority for additional Low-Income Housing Tax Credit authority. States wishing to make maximum use of this conversion authority could increase their LIHTC cap by 50%. One notable addition to this year’s Budget would require states to give preferences to Housing Credit projects which affirmatively further fair housing.

ENERGY

The most far-reaching and controversial energy and infrastructure policy component of the FY 2017 budget request is set forth in the President’s 21st Century Clean Transportation Plan, funded in part by a new $10.25 per barrel fee on oil. In combination with current law baseline resources, nearly $900 billion would be invested in surface transportation over 10 years, according to the Administration.
Describing the 2015 FAST Act's five-year reauthorization of surface transportation programs as providing “only a modest increase in infrastructure funding,” the Administration seeks an average of $20 billion per year in additional transportation investments. Key components of the Plan include: $10 billion annually allocated to new and existing transit programs; $7 billion annually dedicated to high-speed rail; over $2 billion annually to promote cleaner vehicles; and, $1 billion annually provided for multi-modal freight programs.

The FY 2017 budget also requests that Congress create the Transportation Trust Fund, a successor to the Highway Trust Fund (HTF), which would be broadened in scope. The Plan would allocate oil fee revenues to restore the long-term solvency of the trust fund. The HTF is funded by fuels taxes which have not been increased since 1993 and Congress resorted once again to temporary patches in the FAST Act. In addition, 15% of the oil fee revenues would be used to provide assistance to low-income families to cope with energy costs.

The most politically-charged aspect of the Plan is the $10.25 per barrel equivalent of crude oil fee that would be imposed to produce revenue to offset the infrastructure spending package. The fee would be collected on domestically produced as well as imported petroleum products. However, exported petroleum products would not be subject to the fee and home heating oil would be temporarily exempted. The fee would be phased in evenly over a five-year period beginning October 1, 2016 and would also be adjusted for inflation.

The $10.25 per barrel oil fee proposal in the wake of the recent enactment of the FAST Act make it highly improbable that the Congress in 2016 will approve any comprehensive version of the President's 21st Century Clean Transportation Plan.

To implement the "Mission Innovation" commitment that the president made with other world leaders at the 2015 Paris climate negotiations, the Administration is seeking to double the US investment in clean energy research and development from $6.4 billion in FY 2016 to $12.8 billion in FY 2021.

The FY 2017 request is for $7.7 billion in funding for clean energy R&D across 12 agencies, reflecting a 20 percent increase above the FY 2016 enacted level of $6.4 billion. An additional $1.3 billion in funding sought for deployment support raises the total FY 2017 request to $9 billion for clean energy technology programs.

Approximately 76% of the Mission Innovation-related funding request is dedicated to Department of Energy (DOE) research and development programs including: basic clean energy research ($1.8 billion); sustainable transportation technologies ($880 million); nuclear energy technologies ($804 million); carbon capture ($564 million); renewable energy ($500 million); and, grid modernization ($177 million).

Also included within the Mission Innovation DOE funding is $350 million in funding for the Advanced Research Projects Agency-Energy (“ARPA-E”) which serves as a catalyst for applied clean energy research and development.

INDIVIDUAL TAXES
The Administration said the Budget achieves $955 billion in deficit reduction from “curbing inefficient tax breaks for the wealthy and closing loopholes for high-income households, helping to bring in sufficient revenues to make vital investments while also helping to meet promises made to seniors.” The Budget proposes to expand the Earned Income Tax Credit for workers without qualifying children, which has also generated some interest from Speaker Ryan, and to create a new second earner credit.

In addition to raising capital gains rates, the Budget would impose capital gains taxes on assets to be inherited, with exceptions. The Treasury explanation of the proposal provides that transfers of appreciated property generally would be treated as a sale of the property, meaning the donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another. The amount of the gain realized would be the excess of the asset’s fair market value on the date of the transfer over the donor’s basis in that asset, and would be taxable income to the donor in the year the transfer was made, and to the decedent either on the final individual return or on a separate capital gains return.

The “Buffett Rule” provision would implement a Fair Share Tax under which taxpayers earning over $2 million would be subject to a 30% minimum federal income tax rate on adjusted income less a credit for charitable contributions; the tax would be phased in for incomes between $1 million and $2 million, with those taxpayers paying a portion of the extra tax required to get them to a 30% effective tax rate. A charitable credit would be applied equal to 28% of itemized charitable deductions allowed after application of the overall limit on itemized deductions (i.e., the Pease limitation).

The Budget again proposes to limit to 28% the value of certain individual itemized deductions and income exclusions that would otherwise reduce taxable income in the top three individual income tax rate brackets of 33, 35, and 39.6%. The 28% limit is applicable to any tax-exempt State and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and IRAs, the deduction for income attributable to domestic production activities, certain trade or business deductions of employees, moving expenses, contributions to health savings accounts and Archer MSAs, and interest on education loans. It would raise $646 billion over 10 years.

EDUCATION

The Obama administration, in its FY 2017 Budget, proposes to replace the Lifetime Learning Credit and student loan interest deduction with an expanded American Opportunity Tax Credit (AOTC), which was recently made permanent as part of the 2015 PATH Act. The expanded AOTC would: be available for five years, as opposed to four years under current law; be open to students enrolled less than half-time; increase the refundable portion of the AOTC; and index the credit for inflation. In addition, the Administration would exclude Pell Grants from income when calculating AOTC eligibility. The Obama administration also seeks to create a new $5,000 tax credit for businesses that hire graduates from community and technical colleges.
The Budget includes new proposals to expand employer-provided retirement savings coverage, including a proposal to expand the availability of Multiple Employer Plan (MEPs) arrangements by removing the ‘common bond’ requirement under existing law. The MEPs proposal closely tracks a number of bipartisan legislative proposals in Congress, including a proposal that was recently the subject of a Senate Finance Committee hearing.

The Budget spotlights the initiatives that have been launched in a handful of states to create state-run retirement plans for private sector workers. The Labor Department has issued guidance and proposed regulations intended to ease concerns that these plans run afoul of ERISA. A White House Fact Sheet said DOL will make the regulations final this year.

The Budget proposes demonstration funding for nonprofits and States to design, implement, and evaluate new approaches to provide more portable retirement and other employer-provided benefit coverage.

Once again, the Budget includes an Auto-IRA provision as part of the “Opportunity for All” section. This year’s Budget renews last year’s proposal providing a small employer ‘start-up’ cost tax credit. Also, this year’s proposal would triple the existing small business credit for start-up costs for small employers who do not currently offer a plan if they offer a qualified retirement plan. Another element of this year’s plan would allow small employers creating a new qualified plan a credit of $500/year for three years if their new plan includes auto-enrollment.

With regard to expanding penalty-free withdrawals for the long-term unemployed, currently, individuals who have received unemployment compensation for 12 consecutive weeks are not required to pay the 10%penalty on early withdrawals from IRAs if the distribution does not exceed the premiums paid during the year for health insurance. Under the proposal, the exception from the 10%penalty would be expanded in several ways. The limit on penalty-free distributions would be increased, and no longer be tied to health insurance premiums. Other changes to current law include making distributions from qualified plans eligible for the exception and an adjustment in the length of time the individual must be unemployed in order to qualify for the exception.

Under current law, qualified retirement plans can exclude or restrict contributions by employees who work less than 1,000 hours in a year. The Administration’s proposal to require retirement plans to allow long-term part-time workers to participate would require 401(k) plans to expand eligibility so that employees who have worked at least 500 hours for three consecutive years can make their own elective contributions.

Also under current law, distributions from 401(k) plans are subject to a 10%penalty except under certain limited circumstances. To remove one possible impediment to plans offering an annuity investment option, the budget provision on facilitating annuity portability proposes to except from the 10%penalty, early distributions forced by the plan’s decision to eliminate the annuity as an investment option in the plan.
The Budget again proposes giving the Pension Benefit Guaranty Corporation (PBGC) board the authority to increase premiums, calling for $15 billion in additional premiums over the next decade. In a departure from past budgets, this year’s version expresses the Administration’s view that the premium increases should come only from multiemployer plans by creating a variable rate premium and an exit premium.

Finally, the Budget would allocate $6.5 million to the Department of Labor, along with waiver authority, to help States pilot and evaluate State-based 401(k) type programs or automatic enrollment IRAs for private sector workers.

**LOOPHOLE CLOSERS**

“Loophole closers” listed in the “elements of business tax reform” category include: repeal of the last-in, first-out (LIFO) method of accounting for inventories; repeal of the lower-of-cost-or-market inventory accounting method; and repeal of the excise tax credit for distilled spirits with flavor and wine additives.

The section on “loophole closers” outside of tax reform includes proposals to limit Roth IRA conversions to pre-tax dollars and disallow the deduction for charitable contributions that are a prerequisite for purchasing tickets to college sporting events. The Budget includes the same proposal as previous years to tax “carried interest” as ordinary income (i.e., the partner’s share of income on an investment services partnership interest). The Budget also again proposes to cap, at approximately $3.4 million, contributions to and accruals of additional benefits in tax-preferred retirement plans. It also includes the “Stretch IRA provision” to require non-spouse beneficiaries of retirement plans and IRAs to take distributions over no more than five years.

**ESTATE AND GIFT TAXES**

The Budget includes a section on modifying estate and gift taxes that again calls for making permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45% and the exclusion amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. The proposal would be effective for the estates of decedents dying, and for transfers made, after December 31, 2016.

This section also includes provisions to:
- expand requirement of consistency in value for transfer and income tax purposes;
- modify transfer tax rules for Grantor Retained Annuity Trusts (GRATs) and other grantor trusts;
- limit duration of Generation-Skipping Transfer (GST) tax exemption;
- extend the lien on estate tax deferrals where estate consists largely of interest in closely held business;
- modify GST tax treatment of Health and Education Exclusion Trusts (HEETs);
- simplify gift tax exclusion for annual gifts; and
- expand applicability of definition of executor.
CONSERVATION EASEMENTS

The Budget again includes a series of provisions related to the conservation easement deduction, including strengthening standards for organizations to qualify to receive deductible contributions of conservation easements by requiring such organizations to meet minimum requirements and eliminating the deduction for contributions of conservation easements on golf courses. The Administration also proposes creating a new conservation credit pilot program as an alternative to the current deduction, which was made permanent as part of the year-end 2015 tax bill.