President Obama's FY 2016 budget calls for business tax reform; proposes new international and individual tax increases

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In brief

President Obama on February 2 submitted an FY 2016 budget to Congress that reaffirms his support for 'business tax reform' that would lower the top US corporate tax rate to 28 percent, with a 25-percent rate for domestic manufacturing income. The budget also proposes to make permanent the research credit and certain other business tax provisions, including CFC look-through and Subpart F exceptions for active financing income. The budget includes a number of small business tax reform proposals, including permanent increased limits on expensing and expanded use of cash accounting.

The President's budget sets aside a large number of new and previously proposed tax increases in a reserve fund for 'long-term revenue-neutral business tax reform,' but his budget identifies only part of the revenue that would be needed to support his proposed corporate rate reductions.

Significant new international tax increase proposals include a one-time mandatory 14-percent tax on previously untaxed foreign income and a 19-percent minimum tax on future foreign income. The budget states that 'transition' revenue from the 14-percent toll tax would go primarily to fund surface transportation programs. The budget re-proposes limits on 'excessive' interest deductions and certain other revenue raisers included in previous budgets.

The President's budget proposes roughly $1 trillion in tax increases for upper-income individuals, including new proposals to increase the top capital gains and qualified dividends tax rate to 28 percent, limit step-up in basis for inherited property, and impose a new fee on large financial institutions, as well as previous proposals to limit the value of itemized deductions and impose a 'Buffett rule' minimum tax on higher incomes. The budget also includes a large number of 'loophole closers' and proposals to 'reduce the tax gap' through new compliance measures and increased information reporting. The budget calls for revenue from these proposals to be used to offset the cost of new 'middle-class' tax reforms and to reduce the federal deficit.

The Treasury Department's general explanations of the Administration's FY 2016 revenue proposals are provided in a 312-page Green Book.

In detail

Business tax reform

Building on his 2012 'framework for business tax reform,' the President's FY 2016 budget calls for (1) lowering the top corporate tax rate to 28 percent, (2) providing a 25-percent rate for domestic manufacturing income, (3) reforming international tax rules, (4) simplifying and reducing taxes for small businesses, and (5) broadening the tax base to 'avoid adding to deficits in the short-run or the long run.'

The budget does not specify all of the base broadeners that would be required to offset the cost of lowering the top US corporate rate from 35 percent to 28 percent, but states that the rate reductions 'would be paid for by eliminating dozens of inefficient tax expenditures and through additional structural reforms – addressing accelerated depreciation and reducing the tax preference for debt financed investment.'

Note: Revenue proposals in the President's budget are proposed to be effective generally after December 31, 2015.

New foreign earnings minimum tax proposal:

While President Obama mentioned a 'minimum tax on overseas profits' in his 2012 business tax reform framework, the President's FY 2016 budget is the first time the Administration has laid out specific proposals for a minimum tax on foreign earnings.

Under the Administration's budget proposal, a 19-percent minimum tax would apply to the foreign earnings of US corporations and their controlled foreign corporations (CFCs), less 85 percent of the 'per-country foreign effective tax rate.' So, for example, a CFC viewed as earning income in a given foreign country at a 25 percent effective rate (using rules the budget would apply for this purpose) would owe no US tax (85 percent of 25 percent = 21.25 percent, more than the 19 percent minimum). A CFC earning income in a foreign country at a 0-percent effective rate would owe the full 19 percent minimum US tax.

The tentative minimum tax base for each country would be the total earnings of all business units that are tax resident in that country under foreign law, net of dividends received. The tentative minimum tax would be reduced by an allowance for corporate equity. The minimum tax would be imposed on foreign earnings regardless of whether they are repatriated to the United States, and all foreign earnings of a CFC could be repatriated without further US tax.

Foreign source royalty and interest payments paid to US persons would be taxed at the US statutory rate, but certain income attributable to a foreign branch or to the performance of services abroad would be eligible for taxation at the minimum rate.

The Treasury Department estimates that a 19-percent minimum tax on future foreign earnings would raise $205.9 billion over 10 years.

The Administration also proposes a one-time 14-percent tax on previously untaxed foreign income. A credit would be allowed for the amount of foreign income taxes associated with such earnings, multiplied by the ratio of the one-time tax rate to the otherwise applicable US corporate tax rate. The earnings subject to the one-time tax could then be repatriated without any further US tax.

The Treasury Department estimates that this one-time 14-percent tax on previously untaxed foreign income would raise $268.1 billion over 10 years. The Administration's budget proposes that most of this revenue would be used for surface transportation infrastructure investments, with $29.7 billion going to deficit reduction.

Other new international tax proposals:

The President's FY 2016 budget proposes to extend and make permanent look-through treatment for payments between related CFCs and Subpart F exceptions for active financing income. Previous Administration budgets have proposed temporary extensions of these provisions.

The President's FY 2016 budget also proposes to repeal a delay in the implementation of worldwide interest allocation rules; this provision under current law has been delayed until taxable years beginning after 2020.

Previously proposed international tax measures reserved in the budget for tax reform include proposals that would:

- Restrict deductions for excessive interest of members of a financial reporting group.
- Prevent avoidance of foreign base company sales income through manufacturing services arrangements.
- Create a new category of Subpart F income for transactions involving digital goods or services.
- Restrict the use of hybrid arrangements.
- Limit the application of exceptions under Subpart F for certain transactions that use reverse hybrids.
- Limit the ability of domestic entities to expatriate.

- Prevent elimination of earnings and profits through distributions of certain stock.
- Limit shifting of income through intangible property transfers.
- Modify tax rules for dual capacity taxpayers.
- Disallow deductions for excess non-taxed reinsurance premiums paid to foreign affiliates.
- Tax gain from the sale of a partnership interest on look-through basis.
- Prevent use of leverage distributions from related foreign corporations to avoid dividend treatment.
- Extend section 338(h)(16) to certain asset acquisitions.
- Remove foreign taxes from a section 902 corporation's foreign tax pool when earnings are eliminated.

Other revenue-raising proposals to be reserved for tax reform would:

- Treat publicly-traded partnerships for fossil fuels as C corporations. ***Note***: this is a new proposal.
- Eliminate certain oil and gas preferences, including the domestic manufacturing deduction, expensing of intangible drilling costs, and percentage depletion.
- Eliminate certain coal preferences, including the domestic manufacturing deduction.
- Require that derivative contracts be marked to market with the resulting gain or loss treated as ordinary income.
- Modify treatment of insurance companies and products, including dividends-received deduction for life insurance company separate accounts.
- Repeal LIFO method of accounting
- Repeal lower-of-cost-or-market inventory accounting method.
- Modify depreciation rules for non-commercial general aircraft.
- Modify like-kind exchange rules for real property.
- Conform corporate ownership standards.
- Repeal gain limitation for dividends received in reorganization exchanges.
- Expand the definition of built-in loss for purposes of partnership loss transfers.
- Extend partnership basis limitation rules to non-deductible expenditures.
- Limit the importation of losses under related-party loss limitation rules.
- Deny deduction for punitive damages

Tax increases to offset 'middle-class' tax credits and reduce the federal deficit

New capital gains tax proposals:

As previously announced in advance of his January 20, 2015 State of the Union address, the President's FY 2016 budget proposes to increase the top rates on capital gains and dividend income to 28 percent for joint filers with incomes above $500,000, and proposes to change the estate tax carryover basis rules to limit the ability to "step up" the basis of inherited property. The Treasury Department estimates these changes in capital gains rules would raise $207.9 billion over 10 years.

The limitations on step-up in basis for inherited property would exempt capital gains of up to $200,000 per couple ($100,000 per individual), and provide a separate $500,000 exemption for personal residences ($250,000 per individual). Tangible personal property, other than certain high-value art and collectibles, also would be exempt from capital gains tax.

No capital gains tax would be due on inherited small, family-owned and operated business, unless and until the business is sold. An individual inheriting an interest in a closely held business would have the option to pay tax on gains over 15 years.

Previously proposed individual tax increase proposals would:

- Limit to 28 percent the value of all itemized tax deductions and certain tax exclusions, including tax-exempt interest, employer-sponsored health insurance, and retirement contributions, for individuals with taxable incomes in the 33-percent, 35-percent, or 39.6-percent tax brackets. A similar limitation would apply under the alternative minimum tax. The Treasury Department estimates this proposal to raise $603.2 billion over 10 years.
- Implement a "Buffett Rule" 30-percent minimum tax, with carve-out for charitable giving. The proposed minimum tax would be phased in for modified adjusted gross income starting at $1 million, and would be fully phased in at $2 million. This proposal is estimated to raise $35.1 billion over 10 years.

Fee on large financial institutions

The President's FY 2016 budget includes a new fee on large financial institutions. Specifically, the proposal would impose a 7-basis-point fee on the liabilities of large US financial firms with assets of more than $50 billion. This proposal is estimated to raise $111.8 billion over 10 years.

Additional proposed revenue offsets and 'loophole closers' include proposals to:

- Tax 'carried interest' partnership income as ordinary income.
- Conform self-employment contributions act (SECA) taxes for professional services businesses, including S corporations, limited partnerships, general partnerships, and LLCs taxed as partnerships.
- Limit the total accrual of all individual retirement accounts (IRAs) and other tax-preferred retirement accounts; currently, the maximum permitted accumulation of tax-preferred retirement accounts for an individual age 62 would be approximately $3.2 million.
- Reinstate the estate tax at 2009 levels, with a top rate of 45 percent and a $3.5 million exemption.
- Require current inclusion in income of accrued market discount and limit the accrual amount of distressed debt.
- Require that the cost basis of portfolio stock that is a covered security must be determined using the average basis method.
- Reinstate Superfund taxes.
- Make permanent the FUTA surtax.
- Increase certainty with respect to worker classification.
- Restrict deductions for certain conservation easements.
- Expand 'tax gap' compliance requirements.
- Disallow the deduction for charitable contributions that entitle donors to a right to purchase tickets to sporting events.

Middle-class tax relief

- Provide a new 'second earner' tax credit up to $500 for two-earner married couples, subject to wage limitations.
- Expand child care tax benefits up to $3,000 per child, subject to wage limitations.
- Simplify education tax benefits by consolidating several overlapping education provisions and make permanent and expand the American Opportunity Tax Credit to provide more students up to $2,500 each year over five years toward a college degree.
- Require 401(k) plans to expand eligibility to participate to long-term part-time employees, defined as those working at least 500 hours per year for at least three consecutive years.

Business tax proposals

The budget includes several business tax proposals that are intended to benefit small businesses, and provide incentives for manufacturing, research, clean energy, and infrastructure.

New 'small business' provisions would:

- Allow businesses with gross receipts of less than $25 million to use an overall cash method of accounting, regardless of whether the business holds inventories. Exceptions under current law allowing the overall cash method of accounting to be used by personal service corporations and by business entities that are not C corporations (other than partnerships with a C corporate partner), regardless of size, would continue.
- Extend and increase Section 179 expensing to $1 million. ***Note***: The Administration previously proposed permanently increasing Section 179 expensing to $500,000.

Additional previously proposed business tax incentives include proposals to:

- Enhance and make permanent the research credit.
- Modify and permanently extend the renewable electricity production tax credit.
- Eliminate capital gains taxation on investment in small business stock.
- Modify and permanently extend the New Markets Tax Credit, and other regional growth incentives.
- Extend and modify the work opportunity tax credit.
- Provide tax incentives for locating jobs and business activity in the United States, and remove tax deductions for "shipping jobs overseas."
- Exempt certain foreign pension funds from FIRPTA rules.

The budget also includes several business tax simplification proposals, including:

- Repeal of Section 197 anti-churning rules.
- Repeal of the telephone excise tax.
- Repeal technical terminations of partnerships.

Next steps

Congressional committees will hold a series of hearings on the President's budget. Treasury Secretary Jack Lew is scheduled to testify at a February 3 House Ways and Means Committee hearing and a February 5 Senate Finance Committee hearing.

In a February 2 statement, House Ways and Means Committee Chairman Paul Ryan (R-WI) said that he want to find 'common ground' with the Administration on reforming the tax code and other issues, but the new tax increase proposals in the President's budget 'put up yet another roadblock.'

In his statement, Senate Finance Committee Chairman Orrin Hatch (R-UT) said that the President's budget is a 'retread' of 'top-down redistributive policies,' and called on the President to 'move past political talking points and start working with Republicans and Democrats to find consensus' on tax reform and other issues. The Finance Committee recently established five bipartisan tax reform working groups to develop proposals for tax reform legislation.

The takeaway

The release of the President's budget marks an early point in the debate over tax reform. While parts of the President's budget will be rejected by the Republican-controlled Congress, both President Obama and key Republican leaders in the House and Senate have indicated that they plan to focus on finding areas of common ground in an effort to enact tax reform legislation.

With the focus now turning to the House Ways and Means Committee and the Senate Finance Committee, it will be important to stay engaged in the tax reform discussion.

For more details on this year's key tax policy issues,
see the PwC 2015 Tax Policy Outlook: Opportunities and challenges ahead

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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