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Tax Provisions in Administration's FY 2016 Budget Proposals

Public Investment Management

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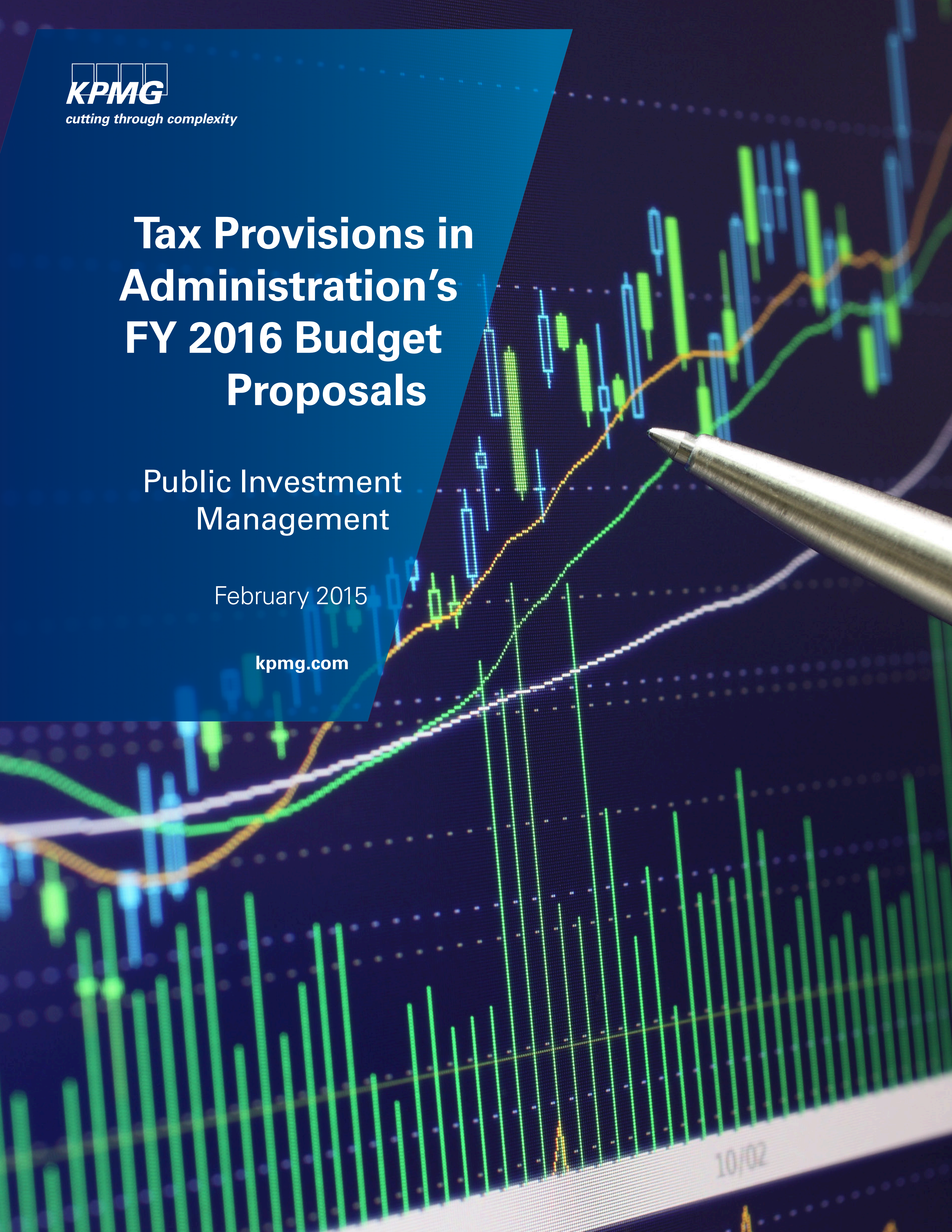

HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO PUBLIC INVESTMENT MANAGEMENT

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals relating to public investment management. Other booklets will address proposals relating to the following topics:

- Insurance
- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Passthrough Entities
- Closely Held Businesses & Their Owners
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Compensation, Benefits, & Qualified Plans
- Energy & Natural Resources
- Real Estate
- Taxation of Individuals

Background

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016).

Among other things, the president proposed a six-year $478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations. This tax would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate.

The president also proposed a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

Many of the “general” business tax proposals in the FY 2016 budget are familiar, having been included in previous budgets. These proposals include, for example:

- Reforms to the international tax system
- Limitations on the ability of domestic entities to expatriate
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Modification of the like-kind exchange rules
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget and are described in more detail later in this booklet.

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to various exceptions and exclusions. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

Tax Proposals of Interest to Public Investment Management

Selected Changes for Advisors

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

The administration's FY 2016 budget includes a new proposal that would impose a one-time 14% tax on a CFC's accumulated earnings that were not previously subject to U.S. tax. A credit would be allowed for the amount of foreign taxes associated with such untaxed earnings multiplied by the ratio of the one-time tax rate to the maximum U.S. corporate rate for 2015. Any untaxed CFC earnings subject to this one-time tax could then be repatriated without any additional U.S. tax liability. The tax due under this proposal would be payable ratably over five years. This proposal would be effective on the date of enactment and would apply to earnings accumulated for tax years beginning before January 1, 2016.

KPMG observation

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

Impose a 19% minimum tax on foreign income

The administration's FY 2016 budget includes a new proposal that would supplement the existing subpart F regime with a new per-country minimum tax on foreign earnings of U.S. corporations and controlled foreign corporations (CFCs). The minimum tax would apply to a U.S. corporation that is a U.S. shareholder of a CFC or that has foreign earnings from a branch or from the performance of services outside the United States. Under the proposal, a foreign branch of a U.S. corporation would be treated like a CFC. The foreign earnings subject to the proposal would be subject to current U.S. taxation at a rate of 19% less 85% of the per-country foreign effective tax rate (the "residual minimum tax rate").

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

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

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

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

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

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

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

Interest expense incurred by a U.S. corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. No deduction would be permitted for interest expense allocated and apportioned to foreign earnings for which no U.S. income tax is paid.

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

The proposal would be effective for tax years beginning after December 31, 2015.

Make permanent the exception under subpart F for active financing income

The administration's FY 2016 budget includes a new proposal that would make permanent the temporary active financing exception to subpart F income for certain insurance, banking, financing, and similar income.

KPMG observation

Although deferral would no longer be available, by extending this exception, active financing income would benefit from the 19% reduced U.S. rate described above rather than being subjected to (28%) U.S. residual tax at the full corporate rate.

Impose a "financial fee"

The administration proposes to impose a financial fee on financial entities. The administration cites excessive risk undertaken by major financial firms as a significant cause of the recent financial crisis and an ongoing potential risk to macroeconomic stability. The administration believes this fee will reduce the incentive for large financial institutions to leverage, reducing the cost of externalities arising from financial firm default as a result of high leverage. The structure of this fee would be broadly consistent with the principles agreed to by the G-20 leaders.[1]

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

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

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

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

According to the administration’s estimates, the fee would raise $112 billion over 10 years and would apply to roughly 100 firms with assets over $50 billion.

The fee would be effective as of January 1, 2016.

Conform corporate ownership standards

The administration’s FY 2016 proposal would amend the “control test” under section 368 to adopt the “affiliation test” under section 1504. Thus, “control” would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation. For this purpose, stock would not include certain preferred stock that meets the requirements of section 1504(a)(4) (certain non-voting, “plain vanilla” preferred stock).

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

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

The proposal would be effective for transactions occurring after December 31, 2015.

KPMG observation

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

Selected Changes to Retirement Plan Rules

Provide for automatic enrollment in IRAs, including a small employer tax credit, increase the tax credit for small employer plan start-up costs, and provide an additional tax credit for small employer plans newly offering auto-enrollment

The administration's FY 2016 proposal would require employers in business for at least two years that have more than 10 employees to offer an automatic IRA option to employees. Contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsors a qualified plan, it would not be required to provide an automatic IRA. However, if the employer excluded from eligibility a portion of the workforce or class of employees, the employer would be required to offer the automatic IRA option to those excluded employees.

Small employers (those with no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable credit for expenses associated with the arrangement of up to $1,000 per year for three years. Such employers would be entitled to an additional non-refundable credit of $25 per enrolled employee, up to a maximum of $250, for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (e.g., because they have 10 or fewer employees).

In addition, the "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE plan would be tripled from the current maximum of $500 per year for three years to a maximum of $1,500 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This credit would not apply to the automatic IRAs.

Small employers would be allowed a credit of $500 per year for up to three years for new plans that include auto enrollment (this is in addition to the "start-up costs" credit of $1,500 per year). Small employers would also be allowed a credit of $500 per year for up to three years if they add auto enrollment as a feature to an existing plan.

The provision would be effective after December 31, 2016.

Facilitate annuity portability

The administration's FY 2016 proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan. The distribution would not be subject to the 10% additional tax.

The proposal would be effective for plan years beginning after December 31, 2015.

Simplify minimum required distribution (MRD) rules

Eliminate MRD requirements for balances of $100,000 or less

The administration's FY 2016 proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed $100,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase-in ratably for individuals with aggregate retirement benefits between $100,000 and $110,000.

The provision would be effective for taxpayers attaining age 70½ years on or after December 31, 2015, and for taxpayers who die on or after December 31, 2015, before attaining age 70 ½ .

Harmonize MRD requirements for tax-favored retirement accounts

The administration's FY 2016 proposal would harmonize the application of the MRD requirements for holders of designated Roth accounts and Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½. Individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½.

The provision would be effective for individuals attaining age 70½ after December 31, 2015 and for taxpayers who die on or after December 31, 2015 before attaining age 70 ½ .

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

The administration's FY 2016 proposal would expand the option available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited-plan or IRA assets by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The provision would be effective for distributions after December 31, 2015.

Limit Roth conversions to pre-tax dollars

The administration's FY 2016 proposal would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includable in income if they were not rolled over. After-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans.

The proposal would apply to distributions occurring after December 31, 2015.

KPMG observation

This provision is new to the FY 2016 budget.

Selected Changes to Individual Tax Rules

Increase capital gain and qualified dividend rates

Under current law, capital gains are taxable only on the sale or other disposition of an appreciated asset. The long-term capital gains tax rate (which also applies to qualified dividends) is generally 20% with an additional 3.8% net investment income tax, which may also be applicable on the gain.

The administration's proposal would increase the tax rate on long-term capital gains and qualified dividends to 24.2% which, in conjunction with the 3.8% net investment income tax, would tax long-term capital gains at 28%. The proposal would be effective for long-term capital gains realized, and qualified dividends received, in tax years beginning after December 31, 2015.

Treat transfers of appreciated property as sales, including transfers on death

Currently, when an individual transfers assets at death, the recipient generally receives the assets with a basis equal to the fair market value of the asset on the date of death. When an individual transfers assets during life, the recipient generally receives the assets with a basis equal to the donor's basis in the assets on the date of the gift. There is no recognition of capital gain on the date of death or gift.

The administration's proposal would treat the transfer of appreciated property (during life or at death) as a sale of the property, with any inherent gain realized and subjected to capital gains tax at that time. Tax incurred on gains deemed realized at death would be deductible for estate tax purposes. Transfers to a spouse or to a charity would not trigger the capital gains tax and would instead carry over the basis of the donor or decedent to the recipient. In addition, the proposal would exempt any gain on tangible personal property (items like furniture, clothing and other household items) other than art and similar collectibles, exempt up to $250,000 per person of gain on a residence, and exempt up to $100,000 per person (indexed for inflation) of other gain. The residence and general exemptions would be portable between spouses such that couples could collectively exempt $500,000 of gain on a residence and $200,000 of other gain.

The exclusion under current law for capital gain on certain small business stock would also apply. The proposal makes tax due on the gain attributable to certain small family-owned and family-operated businesses only once they are actually sold or cease to be family-owned and operated. It also includes an option to pay tax on any gains not associated with liquid assets over 15 years using a fixed rate payment plan.

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

KPMG observation

This is a new provision, i.e., it was not included in a prior budget.

Gifts made during life do not currently receive stepped-up basis but instead have carry-over basis and any related gain is realized when the recipient of the gift sells the asset. As such, the "loophole" the administration is trying to close does not exist in the gift tax context as such gains are ultimately taxed when the asset is sold.

Prior discussions around eliminating stepped-up basis have generally contemplated a corresponding elimination of the estate tax (i.e., suggesting that there should be an estate tax or a capital gains tax at death but not both). This proposal, however, does not appear to affect the existence of the estate tax and seems to contemplate its continuing applicability by allowing for the capital gains taxes triggered at death to be taken as a deduction on the decedent's estate tax return. If this provision and the provision seeking to return the estate tax provisions back to 2009 levels were both fully implemented, an estate worth more than the exemption amount ($3,500,000 per person under 2009 law) could face an estate tax of 45%, a tax on capital gains of 28%, plus, where applicable, state estate and state income taxes. While the interplay of the various taxes is not completely spelled out in detail in the proposal, it is conceivable that, in a high tax state, zero basis assets held at death could bear a total tax of 70-75% (taking into account the potential deductibility of the capital gains tax on the estate tax return).

Impose a new "fair share tax" on upper-income taxpayers

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

The wage base for much of the payroll tax is capped at $118,500 in 2015, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below that amount (although half this amount is the liability of the employer).

The administration's FY 2016 proposal would impose a new minimum tax, called the "fair share tax" (FST), phasing in for taxpayers having $1 million of AGI ($500,000 if married filing separately). The tentative FST would equal 30% of AGI less a credit for charitable contributions. The charitable credit would equal 28% of itemized charitable contributions allowed after the limitation on itemized deductions (the "Pease limitation"). Final FST would be the excess of the tentative FST over regular income tax (including AMT and the 3.8% surtax on investment income, certain credits, and the employee portion of payroll taxes). The tax would be fully phased in at $2 million of AGI ($1 million if married filing separately). AGI thresholds would be indexed for inflation beginning after 2016.

The proposal would be effective for tax years beginning after December 31, 2015.

Reduce amounts of itemized deductions

The administration's FY 2016 proposal would limit the tax value of certain specified deductions and exclusions from AGI, and all itemized deductions. This limitation would reduce to 28% the value of these deductions and exclusions that would otherwise reduce taxable income in the 33%, 35%, or 39.6% tax brackets. A similar limitation would apply under the alternative minimum tax.

The income exclusions and deductions limited by this provision include any tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or from pre-tax employee income, health insurance costs of self-employed individuals, employee contributions to defined contribution retirement plans and individual retirement arrangements, the deduction for income attributable to domestic production activities, certain trade and business deductions of employees, moving expenses, contributions to health savings accounts (HSAs) and Archer medical savings accounts (MSAs), and interest on education loans.

This proposal would apply to itemized deductions after they have been reduced by the statutory limitation on itemized deductions for higher income taxpayers.

The Green Book does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 36% tax bracket with a $10,000 itemized deduction or exclusion would be able to reduce their tax liability by only $2,800 on account of the deduction or exclusion, rather than $3,600—a tax increase of $8 per $100 of itemized deductions compared with current law.

This provision would be effective for tax years beginning after December 31, 2015.

Modifications to Financial Products Rules

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

The timing and character of gain or loss on derivative contracts may vary under current law depending on how the contracts are classified or traded. For example, gain or loss with respect to a forward contract is generally recognized only when the contract is transferred or settled and is generally capital if the contract is a capital asset in the hands of the taxpayer. Certain futures contracts, in contrast, must be marked to market with capital gain or loss treated as 60% long-term and 40% short-term. Furthermore, certain options that are otherwise similar may be subject to disparate tax treatment depending on whether they are entered into over-the-counter or traded on certain exchanges.

Similar to the administration's FY 2015 proposal, the administration's FY 2016 proposal would generally require that a "derivative contract," as defined in the proposal, be marked to market annually (no later than the last business day of a taxpayer's tax year). Gain or loss would be recognized for tax purposes and would be treated as ordinary and as attributable to a trade or business of the taxpayer for purposes of section 172(d)(4). The source of income associated with a derivative would continue to be determined under current law. The proposal would also eliminate or amend a number of other provisions of the Code that address specific taxpayers and transactions, including section 475 (mark to market for securities dealers), section 1256 (mark to market and 60/40 capital treatment), section 1092 (tax straddles), section 1233 (short sales), section 1234 (gain or loss from an option), section 1234A (gains or losses from certain terminations), section 1258 (conversion transactions), section 1259 (constructive sale transactions), and section 1260 (constructive ownership transactions).

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

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

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

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

The proposal would not, however, apply mark-to-market treatment to a transaction that qualifies as a business hedging transaction. A business hedging transaction is a transaction that is entered into in the ordinary course of a taxpayer's trade or business primarily to manage risk of certain price changes (including changes related to interest rates, currency fluctuations, or creditworthiness) with respect to ordinary property or ordinary obligations, and that is identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. The proposal provides that the identification requirement would be met if the transaction is identified as a business hedge for financial accounting purposes and it hedges price changes on ordinary property or obligations.

The proposal would apply to derivative contracts entered into after December 31, 2015.

KPMG observation

The administration's FY 2016 proposal imposes mark-to-market treatment on derivative contracts only when the value of the derivative contract is determined, directly or indirectly, in whole or in part, by the value of actively traded property. Although the administration's FY 2016 proposal would provide a framework for more uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative contract and thus be subject to mark-to-market treatment. Several details would need to be clarified, such as what constitutes actively traded property and what is an embedded derivative.

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

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

The administration's FY 2016 proposal would require holders of debt instruments with market discount to include market discount currently in taxable ordinary income as it accrues. The proposal would require accrual of market discount on a constant yield basis. The proposal would also limit the accrual of market discount to the greater of: (1) the bond's yield to maturity plus 5%; or (2) the applicable federal rate for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2015.

KPMG observation

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

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

Modification to REIT Rules

Repeal preferential dividend rule for publicly traded and publicly offered real estate investment trusts (REITs)

The administration's FY 2016 budget proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

- As of the record date of the distribution, the REIT was publicly traded
- As of the record date of the distribution—
  - The REIT was required to file annual and periodic reports with the SEC under the Securities Act of 1934

- Not more than one-third of the voting power of the REIT was held by a single person (including any voting power that would be attributed to that person under the rules of section 318)
- Either the stock with respect to which the distribution was made is the subject of a currently effective offering registration, or such a registration has been effective with respect to that stock within the immediately preceding 10-year period

Treasury would also be given explicit authority to provide for cures of inadvertent violations of the preferential dividend rule when it continues to apply and, when appropriate, to require consistent treatment of shareholders.

The provision would apply to distributions that are made (without regard to section 858) in tax years beginning after the date of enactment.

Reporting and Compliance Changes

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

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

For portfolio stock with respect to which the taxpayer has a long-term holding period, the administration's FY 2016 proposal would require taxpayers to determine the basis of stock sold using an average basis method. The average basis method would be applied to all identical shares of portfolio stock with a long-term holding period held by the taxpayer, including stock held through a different broker or in a separate account, but would not apply to shares held in a nontaxable account, such as an individual retirement account. The statute would provide authority to the Secretary to draft regulations applying the average basis method to stock other than portfolio stock. Special rules could also be required to coordinate the average basis method with the rules applicable to stock in passive foreign investment company.

The proposal would apply to portfolio stock acquired after December 31, 2015.

KPMG observation

The proposal would only apply to portfolio stock with respect to which a taxpayer has a long-term holding period, and only to portfolio stock acquired on or after December 31,

2015. However, it does not define portfolio stock. This term is defined in section 246A, but it is not clear that the proposal is relying upon this definition.

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

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

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

The administration's FY 2016 proposal would require certain financial institutions to report the account balance (including, in the case of a cash value insurance contract or annuity contract, the cash value or surrender value) for all financial accounts maintained at a U.S. office and held by foreign persons. The proposal also would expand the current reporting required with respect to U.S. source income paid to accounts held by foreign persons to include similar non-U.S. source payments. In addition, the Secretary would be granted authority to issue Treasury regulations to require financial institutions to report the gross proceeds from the sale or redemption of property held in, or with respect to, a financial account, information with respect to financial accounts held by certain passive entities with substantial foreign owners, and such other information that the Secretary or his delegate determines is necessary to carry out the purposes of the proposal. Finally, the proposal would require financial institutions that are required by FATCA or this proposal to report to the IRS information with respect to financial accounts to furnish a copy of the information to the account holders.

The proposal would be effective for returns required to be filed after December 31, 2016.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. businesses with respect to the proposed expansion of reporting. The addition requiring the furnishing of information to account holders is new to this proposal in 2016 and could further exacerbate these costs and burdens.

This provision was included in the administration's FY 2015 revenue proposal.

Change return filing due dates

Third-party information is used by taxpayers to assist them in preparing their income tax returns. However, many taxpayers do not receive Schedules K-1 before their income tax returns are due.

The administration's FY 2016 proposal would rationalize income tax return due dates so that taxpayers receive Schedules K-1 before the due date for filing their income tax returns. Under the proposal, calendar year S corporation filing deadlines would remain the same, and partnership filing deadlines would be made to conform to the current deadlines imposed on S corporations. Accordingly, all calendar year partnership and all calendar year S corporation returns (Forms 1065 and 1120-S) and Schedules K-1 furnished to partners and shareholders would be due March 15. In addition, returns of calendar year corporations other than S corporations would be due April 15 instead of March 15. Fiscal year partnership returns would be due the 15th day of the third month following the close of the tax year and fiscal year corporations other than S corporations would be due by the 15th day of the fourth month following the close of the tax year.

The proposal would also accelerate the due date for filing information returns and eliminate the extended due date for electronically filed returns. Under the proposal, information returns would be required to be filed with the IRS (or SSA, in the case of Form W-2) by January 31, except that Form 1099-B would be required to be filed with the IRS by February 15. The due dates for the payee statements would remain the same.

The proposal would be effective for returns required to be filed after December 31, 2015.

This provision was included in the administration's FY 2015 revenue proposal.

Require greater electronic filing of returns

Currently, corporations that have assets of $10 million or more and that file at least 250 returns (including information returns) per year and partnerships with more than 100 partners are required to file electronically. Under the administration's FY 2016 proposal, all corporations and partnerships with $10 million or more in assets would be required to file electronically. In addition, regardless of asset size, corporations with more than 10 shareholders and partnerships with more than 10 partners would be required to file their tax returns electronically, and preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file these returns electronically.

Regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as Forms 1042-S, 1099, 1098, 1096, 5498, 8805, and 8966. Any new regulations would be required to balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement if they cannot meet the requirement due to technological constraints, if compliance with the requirement would result in undue financial burden, or as otherwise specified in regulations.

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

Impose a penalty on failure to comply with electronic filing requirements

A return that is required to be e-filed but is instead filed on paper can be treated as a failure to file, but no penalty may result if the corporation is in a refund, credit, or loss position (as the penalty is based on the underpayment of tax). The administration's FY 2016 proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The penalty would be $25,000 for a corporation and $5,000 for a tax-exempt organization unless reasonable cause for the failure to file electronically is established. For failure to file in any format the existing penalties would remain and the proposed penalty would not apply.

The penalty would be effective for returns required to be electronically filed after December 31, 2015.

These provisions were separately included in the administration's FY 2015 revenue proposal.

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