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Tax Provisions in Administration's FY 2016 Budget Proposals

Taxation of Individuals

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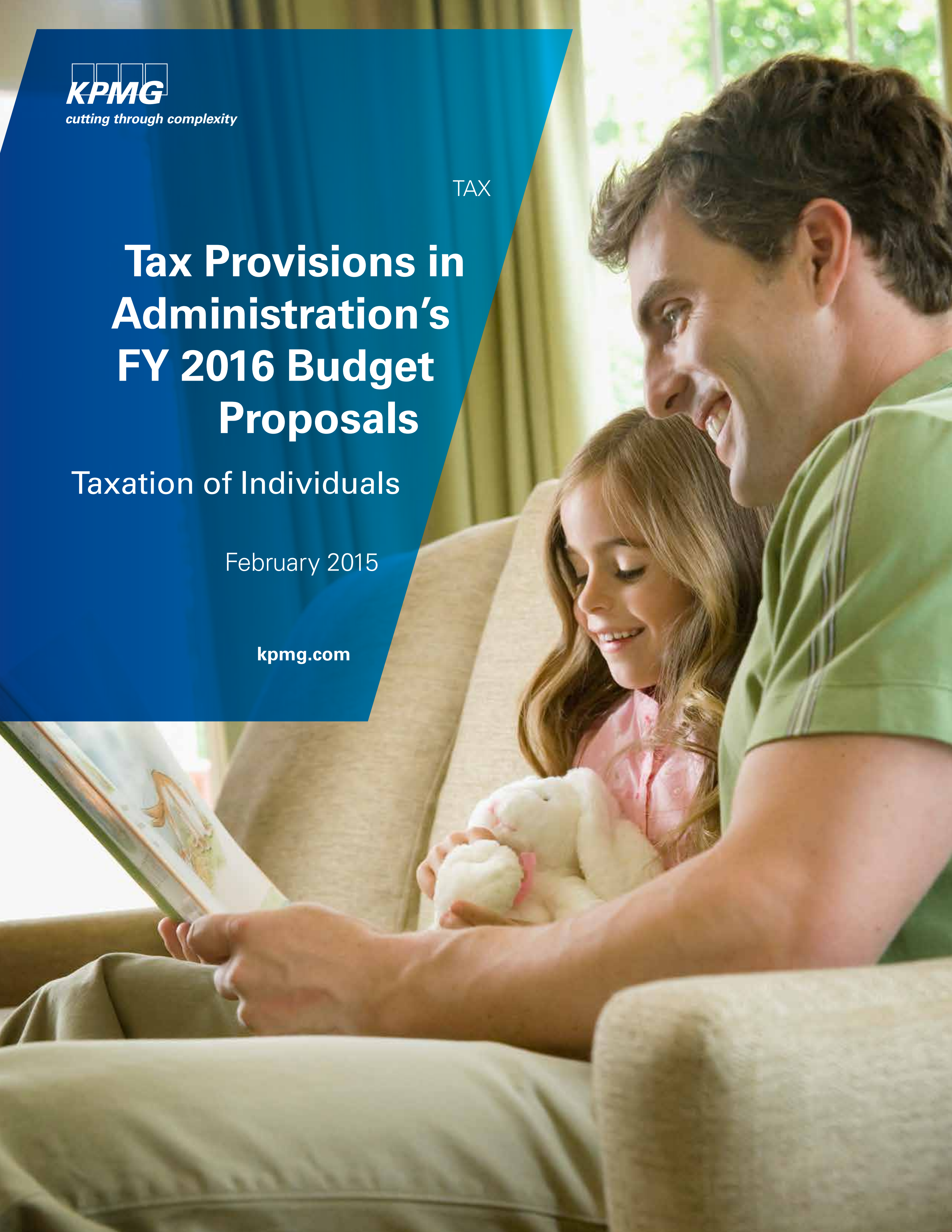

HIGHLIGHTS OF TAX PROPOSALS RELATING TO INDIVIDUALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET

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 that may be of interest to individuals. Other booklets will address proposals relating to among the following topics:

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

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
- Mark-to-market of financial derivatives
- 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.

The budget also includes a host of proposed changes to the individual income tax system, which are highlighted in this booklet. Many of these changes are familiar, including proposals to:

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the “Fair Share Tax”) of 30% of AGI
- Limit the total accrual of tax-advantaged retirement benefits
- Restore the estate, gift, and GST parameters to those in effect in 2009

One of the key sets of proposed revisions involves reforms to the taxation of capital gains for upper-income taxpayers. The highest tax on capital gains would be increased from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property generally would be treated as a sale of the property. Thus, the donor or deceased owner of an appreciated asset would be subject to capital gains tax on the excess of the asset’s fair market value on the date of the transfer over the transferor’s basis. The proposal provides a $100,000 per-person exclusion for gains realized by reason of death, and would continue the current law exclusion for principal residences. Relief also would be provided to lessen the immediate impact of the proposed change on transfers of small businesses. These changes would raise about $208 billion over 10 years.

Revenue from imposition of new taxes on upper-income taxpayers would be used in part to offset tax preferences to middle and lower-income taxpayers, such as:

• Increasing the maximum child and dependent care credit
• Permanently extending increased refundability of the child tax credit
• Expanding and making permanent the earned income tax credit
• Creating a new $500 “second earner” tax credit
• Permanently extending the American opportunity tax credit

Individual Tax Proposals

Tax Increases and General Revenue Raising Proposals

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.

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

The Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 39.6% 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 $3,960—a tax increase of $11.60 per $100 of itemized deductions compared with current law.

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

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 15%, or 20% for taxpayers in the 39.6% income tax bracket, with an additional 3.8% net investment income tax, which may also be applicable on the gain for taxpayers whose AGI exceeds certain thresholds ($250,000 for married couples filing jointly, $125,000 for married couples filing separately, $200,000 for single taxpayers).

The administration's proposal would increase the tax rate on long-term capital gains and qualified dividends for individuals in the 39.6% income tax bracket from 20% 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 generally 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 "minimum" tax on higher 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.

Repeal Dependent Care Flexible Spending Accounts

Some individuals receive dependent care assistance from their employers, either directly or through being permitted to set aside funds for child and dependent care in a flexible spending account (FSA).

The administration's FY 2016 proposal would repeal dependent care flexible spending accounts on the grounds that these are not universally offered (causing inequities between families) and can result in loss of income if the allocated amount is not spent.

Treat income from certain carried (profits) interests as ordinary

The administration's FY 2016 proposal includes a measure to tax carried interests in investment partnerships as ordinary income, effective for tax years ending after December 31, 2015. If enacted, this proposal could affect individuals that own profits interests in certain kinds of partnerships.

The proposal appears to be substantially the same as the proposal that was included in the administration's budget for the previous fiscal year. The proposal, however, reflects a different approach than that taken in the *Tax Reform Act of 2014* proposed by the former Chairman of the House Ways and Means Committee, Dave Camp, in the last congress.

The Green Book generally indicates that the proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. The administration's proposal continues to provide exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

As was the case for the previous fiscal year's budget proposal, the Green Book continues to indicate that:

> …to ensure more consistent treatment with the sales of other types of businesses, the [a]dministration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

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

Credits, Incentives, and Exclusions

Provide a Second-Earner Tax Credit

The administration's FY 2016 proposal would introduce a credit for two-earner married couples who file jointly, effective for tax years beginning after December 31, 2015. This would be a non-refundable credit equal to a percentage of the lower earner's income from wages or self-employment of up to $10,000. The credit rate would be 5% and would phase down by half a percentage point for each $10,000 of AGI over $120,000. Thus, the maximum credit would be $500 and it would be fully phased out at AGI over $210,000. The maximum creditable earned income ($10,000) and the phase-out threshold ($120,000) would be indexed for inflation after 2016.

KPMG observation

This proposed credit for two-earner married couples would do little to mitigate the "marriage penalty" whereby two individuals with income subject to tax in the 28% bracket or higher pay more tax as a married couple than they would as two single individuals.

Permanently extend increased refundability of the child tax credit

Under current law, individual taxpayers can claim a $1,000 tax credit for each qualifying child. A qualifying child must satisfy criteria as to: (1) relationship to taxpayer; (2) residence with the taxpayer; (3) support, in that the child has not provided more than half of his or her own support; and (4) age, in that the child must be under the age of 17 years. The child must also be a U.S. citizen, national or resident.

The child tax credit is partially refundable under current law, meaning that the credit can be claimed by working taxpayers who have no individual income tax liability. The threshold amount of earned income used to calculate the refundable amount was reduced from $10,000 to $3,000 (thus increasing the refundable amount) for tax years 2009 through 2017. Thereafter, however, the threshold will revert to $10,000, indexed for inflation after 2001.

The administration's FY 2016 proposal would make permanent the $3,000 earned income threshold, and this amount would not be indexed for inflation. The purpose of this proposal is to provide additional relief to low-income working families by removing the indexation requirement, which would otherwise prevent an increasing number of such families from qualifying for this relief each year (because the income of low-income taxpayers has failed to keep pace with inflation).

This change would be effective for tax years beginning after December 31, 2017.

Permanently extend earned income tax credit (EITC) for larger families and married couples

The administration's FY 2016 proposal would increase the availability of the EITC by: (1) permanently extending the EITC for larger families and married couples; (2) expanding the EITC for workers without qualifying children; and (3) simplifying the rules for claiming the EITC for workers without qualifying children.

The EITC is a refundable credit targeted towards low and moderate-income working taxpayers. The amount of EITC is based on the number of qualifying children in the taxpayer's household, the taxpayer's levels of adjusted gross income and earned income, and the taxpayer's filing status.

Under current law, the phase-in rate (at which each additional dollar of earned income results in a larger credit) for families with three or more qualifying children is set at 45% for tax years through 2017, but would thereafter revert to 40%. In addition, the phase-out range (where each additional dollar of income results in a smaller credit) for married couples is $5,000 above the level for unmarried taxpayers for tax years through 2017 but would revert thereafter to $3,000 above the level for unmarried taxpayers.

The administration's FY 2016 proposal would permanently fix the level for the phase-out range for married couples at $5,000 above that for unmarried taxpayers and would permanently fix the phase-in rate for families with three or more children at 45%.

These changes would be effective for tax years after December 31, 2017.

In addition, the administration's FY 2016 proposal would increase the EITC for workers without qualifying children by doubling the phase-in and phase-out rates for such individuals from 7.65% to 15.3%, thereby doubling maximum credit from approximately $500 to approximately $1,000. The age range of individuals eligible to claim the EITC for workers without qualifying children would be expanded from 25-65 years to 21-67 years. For married taxpayers filing jointly, the credit could be claimed if either spouse falls within the age range.

Finally, the administration's FY 2016 proposal would simplify the rules for claiming the EITC for workers without qualifying children. Under current law, certain taxpayers with low wages who do not have any qualifying children may still be eligible to claim the EITC in a smaller amount than for workers with qualifying children. However, such taxpayers would be allowed no EITC if they reside with a qualifying child whom they do not claim as a qualifying child (because, for example, the child is claimed by another individual in the household).

The administration's FY 2016 proposal would allow otherwise eligible taxpayers to claim the EITC when such taxpayers reside with children whom they do not claim.

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

Permanently extend the American opportunity tax credit (AOTC)

The AOTC was introduced to replace the Hope scholarship credit for tax years 2009 through 2017. Under current law, the AOTC would expire for tax years after 2017 and the Hope scholarship credit would again become effective for such tax years.

The AOTC can be claimed for 100% of the first $2,000 of qualified tuition and related expenses and 25% of the next $2,000 of such expenses, for a total maximum credit of $2,500 per student per year. The AOTC is phased out for married taxpayers filing jointly with adjusted gross income between $160,000 and $180,000 ($80,000 and $90,000 for all other taxpayers.)

The AOTC is available for the first four years of college whereas the Hope scholarship credit was only available for the first two years. In addition, the AOTC has a higher phase-out range (making it available to taxpayers with higher incomes) and is partially refundable (providing a benefit to low-income families without sufficient income tax liability.)

The administration's FY 2016 proposal would make the AOTC a permanent replacement for the Hope scholarship credit. This change would be effective for tax years after December 31, 2017.

Modify child and dependent care credit

Under current law, a nonrefundable tax credit is allowed to certain working taxpayers for up to 35% of their child and dependent care expenses, limited to $3,000 of eligible expenses for one child or dependent, and $6,000 for two or more. The 35% rate decreases by one percentage point for every $2,000 (or part thereof) of AGI over $15,000 until the percentage reaches 20% for AGI above $43,000.

In addition, the income level at which the child and dependent care credit phases down would be increased from $15,000 to $120,000, such that the rate would reach 20% at income above $148,000. Taxpayers with children under age five could claim a credit of up to 50% of expenses up to $6,000 (or $12,000 for two children under age five). The rate for this young child credit would phase down at a rate of one percentage point for every $2,000 (or part thereof) of AGI over $120,000 until the rate reaches 20% for taxpayers with AGI above $178,000. The expense limits and phase down thresholds would be indexed for inflation after 2016.

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

Extend exclusion from income for cancellation of certain home mortgage debt

Gross income generally includes income realized from the discharge of indebtedness. Under current law, an exception to this general rule exists for qualified principal residence interest (QPRI), which is acquisition indebtedness with respect to a taxpayer’s principal residence, limited to $2 million ($1 million if married filing separately). Pursuant to this exception, taxpayers are allowed to exclude income from the discharge of QPRI. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for QPRI relief, which applies to debt forgiven in calendar years 2007 through 2014.

The administration’s FY 2016 proposal would extend the exclusion from income for QPRI to amounts that are discharged before January 1, 2018, and to amounts that are discharged pursuant to an agreement entered into before that date.

Exclude from gross income subsidies from public utilities for purchase of water runoff management

Under current law, subsidies paid to an individual by a water utility for the purchase of water conservation measures would generally be included in the gross income of the individual under section 61.

The proposal would exclude from the gross income of any individual the value of a subsidy provided by a public utility for the purchase of qualifying water conservation or storm water management measures. Qualifying measures include items that reduce water consumption, manage storm water runoff in a dwelling and several other categories.

The proposal would exclude from gross income subsidies provided after December 31, 2015.

Education Tax Provisions

In addition to the proposed permanent extension of the American Opportunity Tax Credit (AOTC), the administration's FY 2016 proposal would make changes to the tax benefits for education in five principal areas.

Expand and Modify AOTC

First, the administration's FY 2016 proposal would expand and modify the AOTC and repeal the lifetime learning credit (LLC). The LLC is a credit of 20% of up to $10,000 in qualified tuition and related expenses that may be claimed for an unlimited number of years.

AOTC is currently available for the first four years of post-secondary education. Pursuant to the administration's FY 2016 proposal, the AOTC would be available for the first five years of post-secondary education and for five tax years. Students studying less than half-time would be eligible to claim a part-time AOTC equal to 50% of the first $2,000 of eligible expenses plus 12.5% of the next $2,000 of eligible expenses, whereas students studying at least half-time would continue to be eligible as under current law. However, students who can be claimed as a dependent on someone else's tax return would no longer be able to claim the non-refundable portion of the AOTC on their own returns.

The refundable portion of the AOTC would be increased to $1,500 of the otherwise allowable credit for students studying at least half-time and to $750 for students studying less than half-time. The procedure for claiming this credit would be simplified. The expense limits and the refundable portion would be indexed for inflation after 2016.

Exclude Pell grants from income

Second, Pell grants would be made excludible from income. Pell grants are post-secondary education federal grants sponsored by the U.S. Department of Education. Pell grants (like most scholarships) are excluded from gross income (and are therefore not subject to tax) to the extent they are used by students to pay for qualified tuition and related expenses. Pell grants can also be used to pay for expenses other than qualified tuition and related expenses such as room and board or other living expenses. To the extent Pell grants are used to pay for such living expenses, they are not excluded from income and are therefore subject to tax.

The administration's FY 2016 proposal would make Pell grants excludable from gross income without regard to whether they are used for qualified tuition and related expenses or for other expenses such as living expenses. This would provide that the tax benefits a student can receive from the AOTC are not reduced by the Pell grant, and would also remove the complexity involved in trying to maximize the tax benefits from the AOTC in relation to the Pell grant.

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

Modify tuition reporting requirements

Third, the reporting of tuition expenses and scholarship income on Form 1098-T would be modified. The administration's FY 2016 proposal would require institutions of higher learning to report amounts received for qualified tuition and related expenses, repealing the option, as under current law, of reporting amounts billed. In addition, any entity issuing a scholarship or grant in excess of $500 (indexed for inflation after 2016) that is not processed or administered by an institution of higher learning would be required to report the amount on Form 1098-T.

Repeal deduction for student loan interest and provide exclusion for certain debt relief and scholarships

Fourth, the student loan interest deduction would be repealed and an exclusion would be provided for certain debt relief and scholarships. The administration's FY 2016 proposal would repeal the deduction for student loan interest for new students. New students would benefit instead from the expanded AOTC and from income-driven repayment options targeted at reducing the burden of student loan repayment.

The administration's FY 2016 proposal would also conform the tax treatment of loan amounts repaid by the Indian Health Service (IHS) scholarship program and the IHS loan forgiveness program to the tax treatment of loan amounts paid by the National Health Service Corps (NHSC) and certain state programs intended to increase the availability of health care services to underserved populations. In addition, the tax treatment of IHS Health Professions Scholarships would be conformed to the tax treatment of NHSC scholarships and Armed Forces Health Professions (AFHP) scholarships. Participants in the NHSC and AFHP loan and scholarship programs and certain state programs are currently eligible for beneficial exclusions not available under the IHS programs.

Repeal educations savings accounts and reduce benefits for 529 plans

Fifth, the administration's FY 2016 proposal would repeal Coverdell education savings accounts (ESAs) and would reduce the federal tax benefits allowed to qualified tuition programs (QTPs), also known as 529 plans. Under current law, contributions to Coverdell ESAs and QTP plans are not deductible. Contributions to Coverdell ESAs are limited to $2,000 per year and are subject to phase-out for taxpayers with modified adjusted gross income (AGI) between $95,000 and $110,000 ($190,000 and $220,000 for taxpayers filing a joint return). Contributions to QTPs are effectively unlimited and are not subject to income limitations. Investment earnings in both plans accrue tax free and distributions for qualified expenses are not subject to tax.

Pursuant to the administration's FY 2016 proposal, distributions of earnings from a QTP after the date of enactment would be includible in the income of the student beneficiary, but not of the account holder.

The education proposals outlined above would generally be effective for tax years beginning after December 31, 2015, except that the proposals concerning student loan forgiveness would be effective for discharges of loans after December 31, 2015, and the proposals concerning expanded disclosure of taxpayer information would be effective on enactment.

Retirement Savings Plan Proposals

Provide for automatic enrollment in IRAs

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.

Expand penalty-free withdrawals for long-term unemployed

The administration's FY 2016 proposal would expand the exception from the 10% additional tax for early withdrawal from a qualified retirement plan to include distributions to long-term unemployed individuals from an IRA, 401(k), or other tax-qualified defined contribution plan.

An individual would be eligible for this exception to the 10% additional tax on any distribution from an IRA, 401(k), or other tax-qualified defined contribution plan if the following conditions are met:

(1) The individual has been unemployed for more than 26 weeks by reason of a separation from employment and has received unemployment compensation for that period,

(2) The distribution is made during the tax year in which the unemployment compensation is paid or in the succeeding tax year

(3) The aggregate of all such distributions does not exceed certain annual limits

The exception would apply to distributions, but such distributions may not exceed half of the aggregate fair market value of the individual's IRAs, 401(k), and other tax-qualified defined contribution plans. However, an individual would be eligible for this exception for the first $10,000 of otherwise eligible distributions, even if that amount is greater than half the aggregate fair market value of such plan benefits.

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

Require retirement plans to allow long-term part-time workers to participate

The administration's FY 2016 proposal would require section 401(k) plans to expand participation eligibility to employees who worked at least 500 hours per year, for at least three consecutive years, with the employer. The proposal would not require expanded eligibility to receive employer contributions such as matching contributions.

Employers would receive nondiscrimination testing relief from top-heavy vesting and top-heavy benefit requirements after expanding the eligibility group.

The provision would apply to plan years beginning after December 31, 2015.

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.

Eliminate Minimum Required Distribution (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.

Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years

Under the administration's FY 2016 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries. Eligible beneficiaries include any beneficiary who, as of the date of the account holder's death, is: (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant or IRA owner; or (4) a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner. However, in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

Any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The provision would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2015. The requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would apply to participants or IRA owners who die before January 1, 2015, but only if the beneficiary dies after December 31, 2015. The provision would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

Limit the total accrual of tax-favored retirement benefits

Under the administration's FY 2016 proposal, a taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of $210,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 years is approximately $3.4 million based upon the current AFR of 0.00000002%.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at age 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, when actuarial equivalence is determined by treating the individual as if he or she was still age 62; the maximum permitted accumulation would continue to be adjusted for cost of living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation would automatically increase as well. This also could allow a resumption of contributions for a taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The provision would be effective with respect to contributions and accruals for tax years beginning on or 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.

Other

Modify adoption credit to allow tribal determination of special needs

Under current law, taxpayers that adopt children can claim a tax credit for qualified adoption expenses. The amount of the credit is increased for the adoption of a special needs child. For this increased credit to be available, a state must determine that the child meets the statutory requirements of a "child with special needs." Other government entities, such as Indian tribal governments (ITGs) do not have the authority to make this determination.

The Indian Child Welfare Act was enacted by Congress to allow Indian tribes, instead of the state, to manage adoption programs for the children of their tribal members. These include adoptions involving special needs.

The administration's FY 2016 proposal would amend the tax credit for adoption expenses to allow ITGs to make the status determination of a "child with special needs", so as to accord ITGs the same deference as state agencies for purposes of the tax credit for adoption expenses.

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

Provide relief for certain accidental dual citizens

An individual can become a U.S. citizen at birth either by being born in the United States (or certain territories or possessions) or by having a parent who is a U.S. citizen. Some individuals only become aware when adults of the fact that they have been U.S. citizens since birth. Because U.S. citizens are subject to U.S. income tax on their worldwide income even if they reside abroad, and can also be subject to information reporting obligations, many such individuals wish to relinquish their U.S. citizenship.

Section 877A of the Code imposes a mark-to-market tax on the worldwide assets of individuals who relinquish their U.S. citizenship if they meet a tax liability test ($160,000 in 2015) a net worth test ($2 million) or if they fail to certify their compliance with U.S. federal tax obligations for the five preceding tax years.

Section 877A provides an exception from the tax liability and net worth tests for certain dual citizens who have had minimal contacts with the United States during the 15 years preceding the relinquishment of their U.S. citizenship. Such individuals, however, remain subject to the certification test.

The administration's FY 2016 proposal would exempt an individual from tax under section 877A if the taxpayer meets the following conditions:

- The taxpayer became at birth a citizen of the United States and a citizen of another country
- At all times, up to and including the individual's expatriation date, the taxpayer has been a citizen of a country other than the United States
- The taxpayer has not been a resident of the United States (as defined in section 7701(b)) since attaining age 18½ years
- The taxpayer has never held a U.S. passport or has held a U.S. passport for the sole purpose of departing from the United States in compliance with immigration regulations requiring use of a U.S. passport
- The taxpayer relinquishes his U.S. citizenship within two years after the later of January 1, 2016, or the date on which the individual learns that he is a U.S. citizen
- The taxpayer certifies under penalty of perjury his compliance with all U.S. federal tax obligations that would have applied during the five years preceding the year of expatriation if the individual had been a nonresident alien during that period

Many dual-citizen individuals living outside the United States could be at risk of penalties under U.S. tax law for failure to disclose their ownership of foreign financial assets by filing annual information returns such as Form 8939, *Statement of Specified Foreign Financial Assets*. These filing obligations generally apply only to U.S. citizens and residents, and not to nonresidents. The administration's proposal would mitigate this penalty risk by requiring that such individuals only to certify their compliance with the obligations that apply to nonresidents as opposed to the obligations that apply to U.S. citizens and residents.

The proposal would be effective January 1, 2016.

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