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Tax Provisions in Administration's FY 2016 Budget Proposals

Tax Accounting

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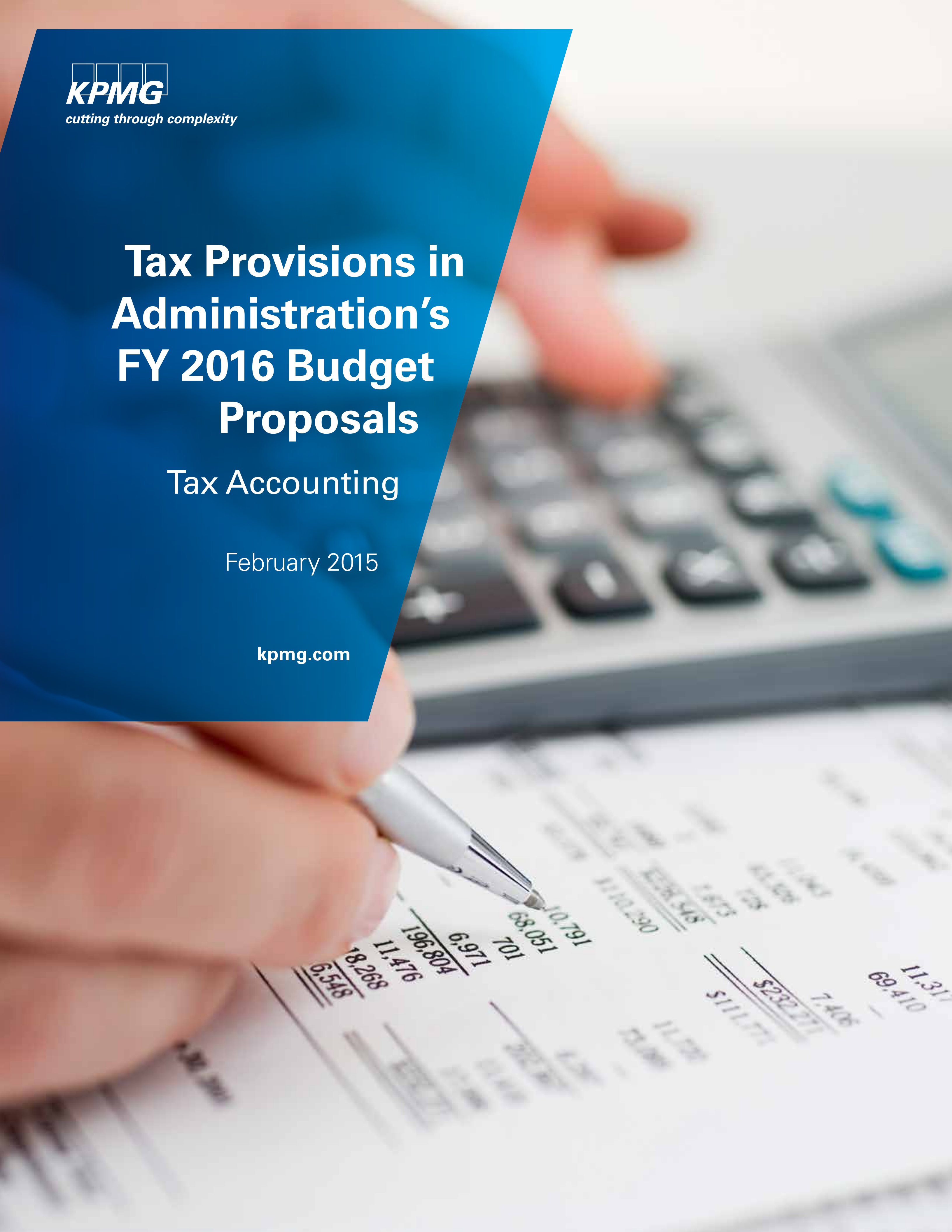

HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO TAX ACCOUNTING

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 Tax Accounting. Other booklets will address proposals relating to the following topics:

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

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

- Reforms to the international tax system
- 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
- Denial of a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation
- Make permanent the Subpart F exception for active financing income
- Make permanent look-through treatment of payments between related CFCs

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. 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.

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Tax Accounting Tax Proposals

This booklet addresses the following budget proposals:

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Cost Recovery

Expand and permanently extend increased expensing for small business

The administration's FY 2016 proposal would make permanent the 2014 increased expensing and investment limitations under section 179. Section 179 provides that, in place of capitalization and depreciation, taxpayers may elect to deduct a limited amount of the cost of qualifying depreciable property placed in service during a tax year. For qualifying property placed in service during the 2010 through 2014 tax years, the maximum deduction amount had been $500,000, and this level was reduced by the amount that a taxpayer's qualifying investment exceeded $2 million. For qualifying property placed in service in tax years beginning after 2014, the limits have reverted to pre-2003 law, with $25,000 as the maximum deduction and $200,000 as the beginning of the phase-out range.

The FY 2016 proposal would extend the increased expensing and investment limitations of $500,000 and $2 million, respectively, for qualifying property placed in service in tax years beginning after 2014. The proposal would increase the expensing limitation to $1 million for qualifying property placed in service in tax years beginning after 2015, reduced by the amount that a taxpayer's qualifying investment exceeded $2 million (but not below zero). These limits, and the cap on sports utility vehicles, would be indexed for inflation for all tax years beginning after 2016. In addition, qualifying property would permanently include off-the-shelf computer software, but would not include real property. An election under section 179 would be revocable with respect to any property, but such revocation, once made, would be irrevocable.

Increase the limitations for deductible new business expenditures and consolidate provisions for start-up and organizational expenditures

The *Creating Small Business Jobs Act of 2010* increased the limit on deductible start-up expenditures, but only for tax years beginning in 2010. The administration's FY 2016 proposal would increase the limitations on a permanent basis and consolidate the provisions for start-up and organizational expenditures, effective for tax years beginning after 2015.

Start-up expenditures under section 195 consist of any amount (other than interest, taxes, or research and experimental expenditures) that would be deductible if paid or incurred in connection with the operation of an existing active trade or business, but that is instead incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; or (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

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Organizational expenditures under sections 248 and 709 are expenditures that are incident to the creation of a corporation or partnership, chargeable to a capital account, and are of a character that, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

Apart from the exception for tax years beginning in 2010, current law permits taxpayers to deduct up to $5,000 of start-up expenditures in the tax year in which the active trade or business begins (with the amount reduced by the amount by which such expenses exceed $50,000) and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins. The 2010 legislation increased the amounts of this rule from $5,000 to $10,000 and from $50,000 to $60,000, but only for a single tax year beginning in 2010.

Similarly, current law permits taxpayers to deduct up to $5,000 of organizational expenditures in the tax year in which the corporation or partnership begins business (with the amount reduced by the amount by which such expenses exceed $50,000) and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the corporation or partnership begins business.

The administration's FY 2016 proposal would permanently allow up to $20,000 of new business expenditures to be deducted in the tax year in which a trade or business begins (with the amount reduced by the amount by which such expenses exceed $120,000) and the remaining amount to be amortized ratably over the 180-month period beginning with the month in which the business begins. New business expenditures would include amounts incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business; and (4) expenditures that are incident to the creation of an entity taxed as a corporation or partnership, that are chargeable to a capital account and are of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

The administration believes that a permanent doubling of currently deductible start-up expenses would support new business formation and job creation, and consolidating the provisions relating to expenditures incurred by new businesses would simplify tax administration and reduce new business owners' tax compliance burden.

Modify Depreciation Rules for Purchases of General Aviation Passenger Aircraft

Under current depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years, and the recovery period for airplanes and other assets (including ground property, but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

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Effective for property placed in service after December 31, 2015, the administration's FY 2016 proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Under the proposal, general aviation passenger aircraft would include any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations). Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.)—as well as all helicopters—would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

Repeal anti-churning rules of section 197

Under current law, as enacted in 1993, section 197 allows the amortization of certain intangible assets (such as goodwill and going-concern value). Prior to the enactment of section 197, many such intangibles were not amortizable. The anti-churning rules in section 197(f)(9) exclude an asset that was not amortizable before the enactment of section 197 from the definition of "amortizable section 197 intangible" if:

- The intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993 (the "transition period") by the taxpayer or a related person;
- The taxpayer acquired the intangible from a person who held it at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or
- The taxpayer grants the right to use the intangible to a person (or a person related to that person) who held or used the intangible at any time during the transition period.

The administration's FY 2016 proposal would repeal the anti-churning rules in section 197(f)(9) effective for acquisitions after December 31, 2015.

Accounting Methods, Character and Other

Expand simplified accounting for small business and establish a uniform definition of small business for accounting methods

Certain businesses are not allowed to use the cash accounting method and must use an accrual method of accounting. These entities include C corporations, partnerships with a C corporation as a partner, and certain tax shelters. Nonetheless, "qualified personal service corporations" and certain small C corporations (generally those with $5 million or less in average annual gross receipts for the prior three tax years, or $1 million or less for farms) are permitted to use the cash method.

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Taxpayers generally must capitalize costs incurred in the production of real or personal property and in the production or purchase of inventory. The uniform capitalization (UNICAP) rules require that these capitalized costs include both direct costs and an allocable portion of indirect costs. The UNICAP rules do not apply to a taxpayer acquiring personal property for resale if the taxpayer had $10 million or less in average annual gross receipts for the three preceding tax years, and certain producers having $200,000 or less of indirect costs in a tax year. Exceptions from the UNICAP rules also apply to certain specified property and expenses, including animals and certain plants produced in a farming business, and inventory items of certain qualifying small business taxpayers.

A taxpayer must account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business, and an accrual method of accounting must be used with regard to purchases and sales whenever inventory accounting is necessary. Certain types of qualifying small taxpayers with inventories may use the cash method of accounting, and may deduct the cost of items purchased for resale and of raw materials purchased for use in producing finished goods in the year the related merchandise is sold, or, if later, in the year in which the taxpayer actually pays for the items: (1) any taxpayer (other than a tax shelter) with average annual gross receipts of $1 million or less for the three preceding tax years, and (2) a taxpayer (other than a farming business) that would not be prohibited from using the cash method under the rules described above and that had $10 million or less in average annual gross receipts. In general, a taxpayer in this second group qualifies only if its business activity is not classified as mining, manufacturing, wholesale or retail trade, or an information industry activity.

The administration's FY 2016 proposal would create a uniform small business threshold at $25 million in average annual gross receipts for the prior three tax years allowing exceptions from certain accounting rules (with adjustments for taxpayers not having sufficient receipts history, and all entities treated as a single employer being treated as a single entity for purposes of the test). Satisfaction of the gross receipts test would allow an entity to elect one or more of the following items: (1) use of the cash method of accounting in lieu of an accrual method (regardless of whether the entity holds inventories); (2) the non-application of the uniform capitalization (UNICAP) rules; and (3) the use of an inventory method of accounting that either conforms to the taxpayer's financial accounting method or is otherwise properly reflective of income, such as deducting the cost of inventory items in the year the related merchandise is sold.

A business whose average annual gross receipts exceeds the threshold would not be able to make an election to use one or more simplified accounting methods for the current tax year and the following four tax years. These rules would supersede the special cash method exception rules that apply to farm corporations, but exceptions allowing the cash method by personal service corporations and by business entities that are not C corporations (other than partnerships with a C corporate partner), regardless of size, would continue. Any tax shelter would continue to be required to use an accrual accounting method. The exceptions from UNICAP that are not based on a gross

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receipts test would continue. The UNICAP farming exceptions would not be changed, but would be affected by the new gross receipts threshold for excepting UNICAP requirements altogether for produced property, as well as the higher threshold for requiring use of an accrual accounting method.

The provision would apply to tax years beginning after December 31, 2015, and the threshold would be indexed for inflation with respect to tax years beginning after December 31, 2016.

The administration believes that a uniform definition of small business for determining applicable accounting rules and a consistent application of a gross receipts test would simplify tax administration and taxpayer compliance, that increasing the threshold amount of average annual gross receipts to $25 million would increase the number of business entities that would be able to obtain relief from complex tax accounting rules, and that indexing the threshold for inflation ensures that the small business definition remains a current reflection of the appropriate level of gross receipts qualifying for the exceptions.

Eliminate capital gains taxation on investments in small business stock

The administration's FY 2016 proposal would make permanent a complete exclusion from income to a non-corporate taxpayer for gain from a sale or exchange of qualified small business stock that is held for at least five years. Under current law, the exclusion is 100% for qualified stock that is acquired after September 27, 2010, through December 31, 2014, and it will drop to 50% for stock acquired after that. Generally, a portion of the excluded gain is a preference item included in computing alternative minimum tax (AMT). However, for stock subject to the 100% exclusion, the excluded gain is not an AMT preference item.

Qualified small business stock is generally stock acquired at its original issue from a C corporation whose:

- Aggregate gross assets, through the time of issue, do not exceed $50 million
- Business constitutes an active trade or business (other than certain disqualified activities) during substantially all of the taxpayer's (acquirer's) holding period

The gain from any small business stock sale that a taxpayer can take into account in computing the exclusion may not exceed $10 million in total and, in any one year, may not exceed 10 times the adjusted basis of the qualified stock the taxpayer disposes of in the year.

The FY 2016 proposal to permanently adopt the complete exclusion would be effective for stock acquired after December 31, 2014. The proposal would also eliminate the AMT preference item for gain excluded under the provision and impose additional reporting requirements.

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Also, under current law, a non-corporate taxpayer may elect to defer recognition of gain on any qualified small business stock held more than six months (and that is not otherwise excluded from income) if the proceeds are reinvested in new qualified stock within 60 days. The administration's FY 2016 proposal would extend this time limit to six months for qualified small business stock the taxpayer has held longer than three years.

Repeal last-in, first-out (LIFO) method of accounting for inventories

Under current law, taxpayers may determine inventory values using the LIFO method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. To use the LIFO method for tax purposes, a taxpayer also must use LIFO for financial reporting (LIFO conformity rule).

For a taxpayer facing rising inventory prices, the LIFO method can provide a tax benefit through lower ending inventories, leading to higher cost of goods sold deductions and lower taxable income. To the extent prices continue rising and the taxpayer acquires or manufactures more goods than it sells during the year, the taxpayer accumulates incremental layers of goods valued at current-year costs, which provide for the deferral of income tax to the extent such costs increase.

The administration's FY 2016 proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2015. Taxpayers would be required to change their method of inventory accounting, resulting in the inclusion of income of prior years' LIFO reserves (the amount deferred under the LIFO method). The resulting section 481(a) adjustment, which is a one-time increase in gross income, would be taken into account ratably over 10 tax years beginning with the year of change.

Repeal lower-of-cost-or-market (LCM) inventory accounting method

Certain taxpayers are permitted to use the lower-of-cost-or-market (LCM) method, under which the taxpayer may write down the carrying values of eligible inventories to replacement or reproduction cost. A taxpayer also may write down the cost of subnormal (damaged) goods to reflect their decline in value.

The administration's FY 2016 proposal would repeal the use of the LCM and subnormal goods methods for the tax years beginning after December 31, 2015. Wash sale rules would prevent taxpayers from circumventing the prohibition. Compliance with these changes would be treated as a change in method of accounting for inventories, and any resulting section 481(a) adjustment would be included in gross income ratably over a four-year period beginning with the year of change.

KPMG observation

Repeal of LCM and subnormal goods writedowns would leave inventory (for tax purposes) at cost, including adjustments necessary under the uniform capitalization rules.

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Deny deduction for punitive damages

A taxpayer may not deduct a fine or similar penalty paid to the government for the violation of law. If a taxpayer is convicted of a violation of the antitrust laws, or a taxpayer's plea of guilty or nolo contendere to a violation is entered or accepted in a criminal proceeding, no deduction is allowed for two-thirds of any amount paid or incurred on a judgment or settlement of certain antitrust civil suits. When neither provision applies, a deduction is allowed for damages paid or incurred as ordinary and necessary expenses in carrying on a trade or business, regardless of whether the damages are compensatory or punitive.

The administration's FY 2016 proposal would prohibit any deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, damages paid or incurred by the insurer would be included in the gross income of the insured person. The insurer would be required to report payments to the insured person and to the IRS.

The provision would apply to damages paid or incurred after December 31, 2015.

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