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Tax provisions in administration's FY 2017 budget proposals

Charitable deductions and exempt organizations

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2017 BUDGET RELATING TO CHARITABLE CONTRIBUTIONS AND EXEMPT ORGANIZATIONS

KPMG has prepared a 103-page **report** that summarizes and makes observations about the revenue proposals in the administration's FY 2017 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 proposals relating to charitable contributions as well as proposals that may be of interest to exempt organizations. Other booklets address proposals relating to other topics.

Background

President Obama on February 9, 2016, transmitted to Congress his fiscal year (FY) 2017 budget, containing the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2016. Although it is not expected that Congress will enact—or even vote on—the president's budget as a whole, the budget represents the administration's view of the optimum direction of spending and revenue policy.

The budget would, according to the White House, reduce the deficit by $2.9 trillion over 10 years. More than $900 billion of that reduction would be attributable to changes in the taxation of capital gains and the reduction of tax benefits for upper income individuals. Reduction would also be achieved through changes in the taxation of international business income (which would raise almost $800 billion in new revenue over 10 years), and from other business tax changes (which would raise approximately $337 billion).

The president also proposes to impose a new fee on oil that would raise almost $320 billion over 10 years. That new revenue would be committed to investment in transportation information infrastructure as part of a multi-agency initiative to build a "clean" transportation system less reliant on carbon-producing fuels.

The budget also reiterates the president's goal of cutting the corporate tax rate and making structural changes and closing loopholes. In *The President's Framework for Business Tax Reform* (February 2012), he proposed cutting the corporate rate to 28%. The budget does not, however, provide sufficient revenue to offset the cost of such a rate reduction.

Business tax proposals

Many other tax proposals in the FY 2017 budget are familiar, having been included in previous budgets, such as:

- Reforms to the international tax system
- Limiting 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
- Marking financial derivatives to market and treating gain as ordinary income
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Imposing a tax on the liabilities of financial institutions with assets in excess of $50 billion

Some previous proposals have been modified significantly, such as expanding the types of property subject to a proposed change to the like-kind exchange rules.

In place of the current system of deferral of foreign earnings, the president is again proposing a minimum tax on foreign earnings above a risk-free return on equity invested in active assets. The minimum tax, imposed on a country-by-country basis, would be set at 19% less 85% of the per-country foreign effective tax rate. The new minimum tax would be imposed on a current basis, and foreign earnings could then be repatriated without further U.S. tax liability.

As part of the transition to the new system of taxation of foreign earnings, the budget would also impose a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to U.S. tax.

Individual (personal) tax revisions

As in the case of businesses, many of the individual (personal) tax proposals in the budget are familiar, including measures that generally would:

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the so-called “Buffett Rule”) 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

Among the set of revisions proposed involves reforms to the taxation of capital gains for upper-income taxpayers, which would offset the cost of extension and expansion of tax preferences for middle- and lower-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, the Green Book* indicates that a transfer of appreciated property would generally 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 budget also includes a proposal to expand the definition of net investment income to include gross income and gain from any trades or businesses of an individual that is not otherwise subject to employment taxes. The change would potentially affect limited partners and members of LLCs, as well as S corporation owners.

In response to concern that employees in employer-sponsored health plans might unfairly become subject to the Affordable Care Act's excise tax on high-cost plans because they reside in states where health care costs are higher than the national average, the president also proposes modifying the threshold for application of that tax.

Treasury's explanation

The Treasury Department on February 9 released an accompanying explanation of the tax proposals of the budget—Treasury's **Green Book*** [PDF 1.85 MB]—which describes those proposals in greater detail.

*General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals

User's guide

$ = U.S. dollar
% = percent
PATH Act = Protecting Americans from Tax Hikes Act of 2015 (enacted December 18, 2015)
Green Book = Treasury's *General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals*

Tax Proposals

This booklet addresses the following budget proposals:

EXEMPT ORGANIZATIONS

Reform excise tax based on investment income of private foundations

The administration's FY 2017 proposal would impose a single tax rate of 1.35% on tax-exempt private foundations. For private foundations that are not exempt from federal income tax, the amount of tax would equal any excess of the sum of the 1.35% excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax-exempt, over the a m o u n t o f income tax imposed on the foundation. The proposal would also repeal the special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions.

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

Enhance electronic filing of returns

Impose e-filing mandatory on exempt organizations: The administration's FY 2017 proposal would require that all Forms 8872 and Form 990 series tax and information returns be filed electronically and would require the IRS to make the electronically filed Forms 8872 and Form 990 series returns publicly available in a machine readable format in a timely manner, as provided in regulations.

The proposal generally would be effective for tax years beginning after the date of enactment. Transition relief would allow up to three additional years to begin electronic filing for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time. In addition, the proposal would grant the IRS discretion to delay the mandate for Form 990-T filers for up to three tax years.

Impose a penalty on failure to comply with electronic filing requirements: The administration's FY 2017 proposal would establish an assessable penalty for a failure to comply with a specific e-file requirement. The penalty would be $5,000 for any tax-exempt organization or employee benefit or welfare plan, 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, 2016. These provisions were separately included in the administration's FY 2016 budget proposals.

Accelerate information return filing due dates

Many information returns, including Forms 1099, 1098, and 1096, are required to be filed with payees by January 31 and with the IRS by February 28 of the year following the year for which the information is being reported. Third-party information is used by taxpayers to assist them in preparing their income tax returns and used by the IRS to determine a taxpayer's compliance with federal tax obligations.

The administration's 2017 budget proposal would 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, 2016. This provision was included in the administration's FY 2016 budget proposals.

Simplify and better target tax benefits for education

Last year, the administration's FY 2016 proposal included a proposal to make permanent the American opportunity tax credit (AOTC). The Protecting Americans from Tax Hikes Act of 2015 (PATH Act), signed into law on December 18, 2015, included a provision to this effect. The administration's FY 2017 proposal would make additional changes to the tax benefits for education in several areas.

Expand and modify the AOTC: The administration's FY 2017 proposal would expand and modify the AOTC such that it would replace the lifetime learning credit (LLC) and the deduction for student loan interest. 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.

The AOTC is currently available for the first four years of post-secondary education. Pursuant to the administration's FY 2017 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. Students studying at least halftime would continue to be eligible to claim an AOTC of 100% of the first $2,000 of eligible expenses and 25% of the next $2,000 of eligible expenses, 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.

Make Pell Grants excludible from income: Pell grants are postsecondary education federal grants sponsored by the U.S. Department of Education. The administration's FY 2017 proposal would make all Pell grants excludable from gross income without regard to whether they are used for qualified expenses or for other expenses such as living expenses. This proposal would provide that the tax benefits a student may receive from the AOTC would not be 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.

Modify reporting of scholarships on Form 1098-T: The reporting of tuition expenses and scholarship income on Form 1098-T would be modified, by requiring any entity issuing a scholarship or grant in excess of $500 (indexed for inflation after 2017) that is not processed or administered by an institution of higher learning to report the amount on Form 1098-T.

Reforms to student loans: The administration's FY 2017 proposal would make four changes to the rules governing student loans.

- First, the student loan interest deduction for new students would be repealed.

- Second, the administration's FY 2017 proposal would exclude the forgiven or discharged portion of a federal student loan from gross income in cases where the loan was forgiven or discharged as part of a program administered by the U.S. Department of Education.

- Third, the administration's FY 2017 proposal would conform various tax treatments of loan amounts repaid by the Indian Health Service (IHS) Scholarship Program, the IHS Loan Forgiveness Program, loan amounts paid by the National Health Service Corps (NHSC) and certain state programs, as well as IHS Health Professions Scholarships, NHSC scholarships, and Armed Forces Health Professions (AFHP) scholarships.

- Fourth, the administration's FY 2017 proposal would allow the Secretary of the Treasury to disclose identifying information to the Department of Education for the purpose of contacting late-stage delinquent borrowers to inform them about their options for avoiding default on their student loans. This proposal would also allow the Department of Education to re-disclose this information to certain lenders, guarantee agencies and educational institutions.

The proposals in relation to the tax benefits for education would generally be effective for tax years beginning after December 31, 2016, except that the provisions concerning student loan forgiveness would be effective for discharges of loans after December 31, 2016, and

the provisions expanding disclosure in relation to delinquent loans would be effective upon enactment.

CHARITABLE CONTRIBUTIONS

Implement the Buffett rule by imposing a new "fair share tax"

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 2016, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below $118,500 (although half this amount is the liability of the employer).

The administration's FY 2017 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 2017.

The proposal would be effective for tax years beginning after December 31, 2016.

Enhance and modify the conservation easement deduction

Under current law, a donor may deduct the fair market value of certain conservation contributions made to a qualified charitable organization. According to the Green Book, although the current tax deduction provides important incentives for conservation, it has been of limited value to some donors while being susceptible to abuse and difficult to administer in other cases. The administration's FY 2017 proposal would modify the conservation easement deduction as follows:

- The proposal would require new regulations, based on the experiences and best practices developed in several States and by voluntary accreditation programs, to

establish minimum requirements for organizations to qualify to receive deductible contributions of conservation easements. The proposal states that an organization would jeopardize its status as a "qualified organization" by accepting contributions that it knows (or should know) are substantially overvalued or do not further an appropriate conservation purpose. The proposal also suggests that the regulations could specify, among other things, that a "qualified organization": (1) must not be related to the donor or to any person that is or has been related to the donor for at least 10 years; (2) must have sufficient assets and expertise to be reasonably able to enforce the terms of all easements it holds; and (3) must have an approved policy for selecting, reviewing, and approving conservation easements that fulfill a conservation purpose.

- The proposal would modify the definition of eligible "conservation purposes" to require that all contributed easements further a clearly delineated federal conservation policy (or an authorized state or tribal government policy) and yield significant public benefit.

- The proposal would require the donor to provide a detailed description of the conservation purpose or purposes furthered by the contribution, including a description of the significant public benefits it will yield. It would also require the donee organization to attest to the accuracy of the conservation purpose, public benefits, and fair market value of the easement reported to the IRS. The proposal would also impose penalties on organizations and organization managers that attest to values that they know (or should know) are substantially overstated or that receive contributions that do not serve an eligible conservation purpose.

- The proposal would amend section 6033 by requiring electronic reporting and public disclosure by donee organizations of the following: (1) deductible contributions of easements, including detailed descriptions of the subject property and the restrictions imposed on the property, the conservation purposes served by the easement, and any rights retained by the donor or related persons; (2) the fair market value of both the easement and the full fee interest in the property at the time of the contribution; and (3) a description of any easement modifications or actions taken to enforce the easement that were taken during the tax year.

- The proposal would eliminate the deduction for contributions of conservation easements of a partial interest in property that is, or is intended to be, used as a golf course.

- The proposal would restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation, by disallowing a deduction for any value of a historic preservation easement associated with the restricted upward

development above a historic building. To maintain consistency, the proposal would also extend the special rules applicable to buildings in registered historic districts to apply to buildings listed in the National Register.

- The proposal would also authorize a pilot of an allocable credit for conservation contributions. The pilot would provide a non-refundable credit for conservation easement contributions as an alternative to the conservation contribution deduction. A federal agency would allocate $100 million in credits per year to qualified charitable organizations and governmental entities, which would allocate the credits to donors. The proposal would permit donors to receive up to a maximum of 50% of the easement's fair market value and carry forward any unused credit amounts for up to 15 years. The Secretary of the Treasury, in collaboration with the Secretaries of Agriculture and the Interior, would be required to report to Congress on the relative merits of the conservation credit and the deduction for conservation contributions, including an assessment of the conservation benefits and costs of both tax benefits.

The proposals would be effective for contributions made after the date of enactment.

Consolidate contribution limitations for charitable deductions and extend the carryforward period for excess charitable contribution deduction amounts

Current law generally limits a donor's charitable contribution deduction to 50% of adjusted gross income (AGI) for contributions of cash to public charities and to 30% for cash contributions for the use of public charities and to most private foundations. A donor may generally deduct up to 30% of AGI for contributions of appreciated capital gain property to public charities and up to 20% to most private foundations. A donor may deduct up to 20% of AGI for contributions of capital gain property for the use of a charitable organization. Donors generally can carry forward excess amounts for five years; however, contributions of capital gain property for the use of an organization exceeding 20% may not be carried forward.

The administration's FY 2017 proposal would simplify these rules by retaining the 50% limitation for contributions of cash to public charities and replacing the deduction limit for all other contributions with a 30% limitation, regardless of the type of property donated, the type of organization receiving the donation, and whether the contribution is to or for the use of the organization. In addition, the proposal would extend the carryforward period for contributions in excess of these limitations from five years to 15 years.

The proposal would be effective for contributions made in tax years beginning after December 31, 2016.

Disallow the deduction for charitable contributions that are a prerequisite for purchasing tickets to college sporting events

Under current law, donors generally must reduce the value of their charitable contributions by the value of any benefits received in exchange. However, current law permits donors to deduct 80% of the value of a contribution made to colleges and universities for the right to purchase tickets for seating at an athletic event. Stating that the 20% disallowance may not accurately represent the value of the right received, the administration's FY 2017 proposal would deny the entire deduction for contributions that entitle donors to a right to purchase tickets to sporting events.

The proposal would be effective for contributions made in tax years beginning after December 31, 2016.

Increase the standard mileage rate for automobile use by volunteers

The administration's FY 2017 proposal would set the standard mileage rate for the charitable contribution deduction equal to the rate set by the IRS for purposes of the medical and moving expenses deduction, rather than the statutory limit of 14 cents per mile. The rate would be adjusted annually to reflect the variable costs of operating a vehicle.

The proposal would be effective for tax years beginning after December 31, 2016.

EMPLOYERS

Require Form W-2 reporting for employer contributions to defined contribution plans

Employers file Form W-2 to provide to each employee an annual statement showing the remuneration paid by the employer to the employee during the calendar year. A copy of the Form W-2 must also be filed with the Social Security Administration, which shares information on the form with the IRS. Employers are required to report an employee's elective deferrals under a cash or deferred arrangement, such as contributions to a 401(k) plan, on the employee's Form W-2. Employers are not currently required to report the employer's contributions to an employee's defined contribution retirement plan on the employee's Form W-2.

The administration's FY 2017 proposal would require employers to report the amounts an employer contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2.

The proposal (included in previous budget proposals) would be effective for information returns due for calendar years beginning after December 31, 2016.

Increase certainty with respect to worker classification

Under a special non-Code provision (*Section 530 of the Revenue Act of 1978*), the IRS is prohibited from reclassifying an independent contractor to employee status, even when the worker may be an employee under the common law rules, if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. In addition to providing so-called "Section 530 relief" to service recipients, the 1978 legislation prohibited the IRS from issuing guidance addressing the proper classification of workers.

The administration's FY 2017 proposal would allow the IRS to require service recipients to prospectively reclassify workers who are currently misclassified. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases, the proper classification of workers may have been unclear. In addition, the proposal would lift the prohibition on worker classification guidance, with Treasury and the IRS being directed to issue guidance that: (1) interprets the common law in a neutral manner; and (2) provides narrow safe harbors and/or rebuttable presumptions. Service recipients would be required to give notice to independent contractors explaining how they will be classified and the implications of such classification. Independent contractors receiving payments totaling $600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold federal income tax from their gross payments at a flat rate percentage selected by the contractor. The proposal would also clarify rules with respect to Tax Court jurisdiction in relevant proceedings and make technical and conforming changes to those rules.

The provision (included in previous budget proposals) would be effective upon enactment, but prospective reclassification of those workers covered by Section 530 would not be effective until the first calendar year beginning at least one year after the date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

KPMG observation

This proposal could result in a significant increase in costs and burdens on U.S. employers that have service providers currently classified as independent contractors. The reclassification to employee status may have wide-spread implications outside of federal employment taxes and affect such matters as workers compensation, unemployment benefits, pension requirements, and state employment taxes.

This provision was included in the administration's FY 2015 and 2016 revenue proposals.

Expand and simplify the tax credit provided to qualified small employers for nonelective contributions to employee health insurance

Substantially similar to last year's proposal, the administration's FY 2017 proposal would expand the group of employers that are eligible for this credit to include employers with up to 50 full-time equivalent employees, and would begin the phase-out at 20 full-time equivalent employees. In addition, the coordination of the phase-outs between the number of employees and the average wage would be amended to provide for a more gradual combined phase-out. The proposal also would eliminate a requirement that the employer make a uniform contribution on behalf of each employee, and eliminate the limit imposed by the rating area average premium.

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

TAX CREDITS

Modify and permanently extend the new markets tax credit (NMTC)

The NMTC is a credit for qualified equity investments (QEIs) made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE), held for a period of seven years. The allowable credit totals 39% of the amount paid to the CDE for the investment at its original issue, and it is apportioned over the seven-year period after the purchase (5% for each of the first three years, 6% for each of the remaining four years). The credit may be recaptured if the entity ceases to be a qualified CDE during this seven-year period, if the proceeds of the investment cease to be used as required, or if the equity investment is redeemed. Only a specific dollar amount of QEIs can be designated each year; the NMTC will expire on December 31, 2019.

The administration's FY 2017 proposal would make the NMTC permanent, with an allocation of $5 billion for each year after 2019, and would permit NMTC amounts resulting from QEIs made after December 31, 2019, to offset alternative minimum tax (AMT) liability.

The proposal would be effective after December 31, 2019.

Reform and expand the low-income housing tax credit (LIHTC)

Similar to last year's budget proposal, the administration proposes the following for FY 2017:

- Provide two ways in which the private activity bond (PAB) volume cap could be converted into LIHTCs:
  (1) States may convert an annual maximum PAB volume cap into LIHTC allocations for the same year. The conversion ratio would be reset each calendar year to respond to changing interest rates.
  (2) Taxpayer may qualify for the 30% present value LIHTC—generally allowed for projects at least 50% financed with tax exempt bonds—without actually getting such financing if there is an allocation of PAB volume cap in the required amount of financing.
- Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income
- Add preservation of publicly assisted affordable housing to allocation criteria
- Remove the qualified census tracts (QCT) population cap
- Implement requirement that LIHTC-supported housing protect victims of domestic abuse

Unlike the FY 2016 proposal, the administration did not propose to change formulas for the 70% or the 30% present value credit rates.

TAX-EXEMPT BONDS

The budget proposal contains a number of provisions that would impact tax-exempt bonds, including the following:

- Provide America Fast Forward Bonds and expand eligible uses
- Allow current refundings of state and local governmental bonds
- Provide a new category of qualified private activity bonds for infrastructure projects referred to as “Qualified Public Infrastructure Bonds”
- Modify qualified private activity bonds for public educational facilities
- Modify treatment of banks investing in tax-exempt bonds
- Repeal tax-exempt bond financing of professional sports facilities
- Modify tax-exempt bonds for Indian tribal governments
- Streamline private activity limits on governmental bonds
- Repeal the $150 million non-hospital bond limitation on qualified section 501(c)(3) bonds
- Increase national limitation amount for qualified highway or surface freight transfer
- facility bonds from $15 billion to $19 billion
- Simplify arbitrage investment restrictions for tax-exempt bonds
- Simplify single-family housing mortgage bond targeting requirements

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