SQUIRE PATTON BOGGS

PRESIDENT'S FY 2016 BUDGET PROPOSAL

# DETAILED ANALYSIS OF THE TAX AND REVENUE IMPLICATIONS

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# INTRODUCTION

As was previewed in the President's State of the Union Address, the Administration's FY 2016 Budget includes approximately US$640 billion in proposed new revenue raisers[1], aimed largely at investment income, large financial institutions, and offshore income. This additional revenue would "invest in helping working families make their paychecks go further, preparing hardworking Americans to earn higher wages, and creating the infrastructure that allows businesses to thrive and create good, high-paying jobs." Below we detail these proposals, dealing first with "adjustments to the baseline," followed by revenue raising proposals, and finally with new tax reductions. While many Republicans have suggested that the President's Budget is a "non-starter," the Administration's proposals will nevertheless serve to help frame further discussions on the budget process generally, as well as on tax reform. We begin first, however, with an executive summary of the President's Budget as it relates to tax and revenue issues.

1 All revenue figures are over a period of 10 years.

# EXECUTIVE SUMMARY

The White House is proposing to increase the top capital gains tax rate to 28%, significantly curtail the stepped-up tax basis on inherited assets, and impose a seven-basis-point fee on the liabilities of roughly 100 of the largest financial institutions. According to President Obama, the revenues raised from these proposals will be dedicated principally to a series of tax credits and incentives "designed to bring middle class economics into the 21st Century." As such, the Budget includes proposals to "better support and reward work," including the creation of a new "Second Earner Credit," an expanded Earned Income Tax Credit (EITC) and child care tax benefits, and the streamlining of education tax incentives. Additionally, the revenue would be used to reform retirement tax incentives and expand savings opportunities, while also helping to pay for the President's recent proposal to make two years of community college free to students. (For more information about the community college proposal, please refer to the "Education" section of our firm's Budget analysis.)

Also notable, the Budget proposes a minimum 19% tax on foreign earnings and a 14% tax on previously untaxed foreign income, but then allows foreign earnings to be repatriated without additional tax. The President proposes using this new revenue to help pay for infrastructure projects as part of the US$478 billion six-year surface transportation reauthorization.

As expected, the Administration is also seeking US$12.9 billion in funding for the IRS for Fiscal Year 2016, which represents an 18% increase from the 2015 enacted level of US$10.9 billion. Notably absent from the Budget, however, is a provision on bonus depreciation. While bonus depreciation was extended through December 31, 2014, President Obama chose not to include such a proposal in the Budget.

Almost immediately upon the Budget's release, Republicans jumped to criticize the Administration's approach, with Speaker John Boehner (R-OH) noting that "the president's budget is about the past, [but] our budget will be about the future." Similarly, both leaders of the congressional tax writing committees indicated their strong opposition to the Budget. According to Senate Finance Committee Chairman Orrin Hatch (R-UT), the Budget "shamelessly panders to the Democratic base and does nothing to put our nation back on sound fiscal footing." Moreover, Chairman Paul Ryan (R-WI) emphasized that this Budget is "more of the same" and that "the president has to demonstrate that he's interested in governing, not just posturing."

Even prior to release, some of the President's proposals were mired in controversy. For example, while the President had originally called for a tax on the earnings from 529 college savings accounts – and actually included that proposal in the Budget – the Administration has already backed away from its position, indicating it does not plan to pursue the tax. Nevertheless, despite Republican opposition to President Obama's Budget, the Administration's proposals serve as a benchmark for negotiations with Congress and will be helpful in framing the debate that is likely to ensue.

# THE CURRENT TAX LANDSCAPE

Before the 113th Congress adjourned, outgoing House Ways and Means Committee Chairman Dave Camp (R-MI) formally introduced H.R. 1, the Tax Reform Act of 2014 – his comprehensive tax reform legislation. Similarly, late last year Chairman Hatch released a nearly 350-page report on the future of comprehensive tax reform, while Chairman Ryan has also vowed to "work with this administration…[in] hope[s] that we can find common ground." The combined efforts of former-Chairman Camp and Chairmen Hatch and Ryan will no doubt frame the debate on tax reform during the 114th Congress.

In the first few weeks of the new Congress, both Chairman Ryan and Chairman Hatch made clear that reforming the tax Code remains their top priority, with Chairman Hatch outlining his seven principles on tax reform: 1) economic growth; 2) fairness; 3) simplicity; 4) permanence; 5) American competitiveness; 6) promoting savings and investment; and 7) revenue neutrality.

Further, Chairman Hatch and Ranking Member Ron Wyden (D-OR) recently announced the formation of the following five bipartisan Senate Finance Committee Working Groups "to spur congressional comprehensive tax reform efforts in the 114th Congress:" (1) Individual Income Tax; (2) Business Income Tax; (3) Savings and Investment; (4) International Tax; and (5) Community Development and Infrastructure. Each of the Working Groups has been tasked with submitting policy proposals by April. According to Chairman Hatch, these Working Groups will be particularly helpful in achieving his goal "to get something done on tax reform this year."

While lawmakers remain divergent on their views as to how to accomplish individual tax reform, they appear to be more closely aligned on corporate tax reform. However, despite early signs that key players like Chairman Ryan may be open to the idea of business-only tax reform, House Ways and Means Committee Republicans recently set their agenda for the year and included both corporate and individual tax reform among their top priorities. While this will not necessarily preclude lawmakers from reaching an agreement on corporate tax reform, it will likely extend and complicate their efforts. Indicative of the difficult road ahead, senior Ways and Means Committee Republican Kevin Brady (R-TX) recently emphasized "if [tax reform efforts don't] work over the next two years, then so be it." Notably, there is a difference between "corporate" tax reform and "business" tax reform given the predominance of pass through entities that do not pay tax and whose owners are subject to the individual tax rates.

Even if lawmakers are able to come to an agreement, fundamental reform will also require the commitment of the President and his active participation in, and support for, the give and take of the reform process. Treasury Secretary Jack Lew, who, following the Budget's release emphasized that it "lay[s] the groundwork for long-term economic growth," recently emphasized that the Administration and lawmakers have a "unique opportunity" to work together in a bipartisan way to accomplish business tax reform, which he suggested has more than a "50/50" chance of being successful.

Further complicating efforts to achieve fundamental reform, a host of issues are likely to be wrapped up in the larger debate. For example, while lawmakers last Congress were able to pass a tax extenders package before adjourning, the legislation only provided a one-year retroactive extension for the 2014 calendar year. As such, effective January 1, 2015, these tax provisions expired again, leaving it to the new Congress to take action on the matter. While Chairman Hatch has suggested that his committee will debate tax extenders early in 2015, he and Chairman Ryan have also indicated that they "wish [they] could get permanency." In taking the first steps to address these expired tax provisions and ensure that they are "part of the overall reform effort," the House Ways and Means Committee soon plans to hold a markup to make permanent seven tax provisions, including section 179 business expensing. Anticipating that these provisions will be successfully reported out of committee, the full House has scheduled a vote for the second week in February.

Another issue addressed in the President's Budget and explained below – which also carried over from the last Congress – is that of corporate tax inversions, with Democrats in both the House and Senate vowing to continue their fight to stop these transactions. In the early weeks of the new Congress, House Ways and Means Committee Ranking Member Sandy Levin (D-MI) and Senator Dick Durbin (D-IL) reintroduced H.R. 415 and S. 198, the Stop Corporate Inversions Act of 2015. However, despite the continued push by Democrats to address inversions through standalone legislation, Chairman Hatch has emphasized that overhauling the tax Code is the best way to tackle the issue. Further, although the Administration issued its September 2014 guidance aimed at inversion transactions, Treasury has yet to issue implementing regulations, indicating that it "can't say any more on timing than what was in the notice." As such, it is clear that corporate inversions will continue to be an issue in the balance on tax reform.

Additionally, after last Congress voted to provide temporary funding to keep the Highway Trust Fund solvent through May 31, 2015, lawmakers in the 114th Congress will be tasked with finding a mechanism to fund the Highway Trust Fund on a long-term basis. Recently, Senators Rand Paul (R-KY) and Barbara Boxer (D-CA) released a proposal that would fund the Highway Trust Fund with revenue generated from the taxation of repatriated earnings. On the House side, with discussions of a gas tax hike fading, more lawmakers appear open to using repatriation to fund the Highway Trust Fund, including House Transportation Committee Chairman Bill Shuster (R-PA). However, the likelihood of moving forward with the bipartisan proposal was called into question as Senate Environment and Public Works Chairman Jim Inhofe (R-IA) indicated that it is "not going to solve the problem…What we're going to try to do [to fund the nation's infrastructure] is do it better." Chairman Hatch similarly pushed back against the proposal, noting that "we can do it without" repatriation, as "repatriation may be necessary for true tax reform." Interestingly, the 6.5% tax on repatriated earnings provided for under the Senate plan stands in stark contrast to President Obama's Budget, which provides for a one-time tax of 14% on previously untaxed foreign income.

It will also be important to consider how the use of dynamic scoring will impact the broader debate in Washington DC surrounding tax reform, as well as the myriad of other tax-related proposals that lawmakers will consider. While Chairman Ryan has suggested that incorporating the macroeconomic effects of legislation in scoring is "reality-based" and will provide a more accurate picture of the impact that legislative proposals will have, some Democrats have suggested that Republicans are "stack[ing] the deck in favor of trying to give another big tax cut, not to the middle class but to millionaires."

# TAX PROPOSAL HIGHLIGHTS FROM THE ADMINISTRATION'S FY 2016 BUDGET

The tax proposals discussed below represent the new and/or significant proposals contained in the Budget. A list of all Budget proposals is available here.

## "Adjustments to the Baseline"

### Permanently Extend Increased Refundability of the Child Tax Credit.

The adjusted baseline for the Budget makes permanent the reduction of the earned income threshold to US$3,000 and would not index the threshold for inflation. This change would be effective for taxable years beginning after December 31, 2017.

### Permanently Extended Earned Income Tax Credit (EITC) for Larger Families and Married Couples.

The adjusted baseline for the Budget makes permanent the expansion of the EITC enacted as part of the American Recovery and Reinvestment Act of 2009 (ARRA) and temporarily extended by the American Taxpayer Relief Act (ATRA).

The Budget would implement a phase-out range for married couples beginning at income levels US$5,000 higher than those for unmarried filers, which is indexed for inflation after 2009. This change would be effective for taxable years beginning after December 31, 2017.

Separately, the Budget would maintain the 45% phase-in rate of the EITC for workers with three or more qualifying children. This change would be effective for taxable years beginning after December 31, 2017.

### Permanently Extend the American Opportunity Credit (AOTC).

The adjusted baseline for the Budget makes the AOTC a permanent replacement for the Hope Scholarship credit. This change would be effective for taxable years beginning after December 31, 2017.

## Revenue Raisers

### Impose a 19% Minimum Tax on Foreign Income.

One of the highlights of the Budget is a proposal to supplement the existing subpart F regime with a per-country minimum tax on the foreign earnings of domestic C corporations (i.e., US corporations) and their controlled foreign corporations (CFCs). The minimum tax would apply to a US corporation that is a US shareholder of a CFC or that has foreign earnings from one of its branches or from the performance of services abroad.

The foreign earnings of a CFC or of any of the US corporation's branches or from the performance of services would be subject to a 19% tax rate less 85% of the per-country foreign effective tax rate (the residual minimum tax rate).

The Budget proposes to calculate the foreign effective tax rate on an aggregate basis with respect to all foreign earnings and the associated foreign taxes assigned to a country for a 60-month period that ends on the date on which the domestic corporation's current taxable year ends, or in the case of CFC earnings, that ends on the date on which the CFC's current taxable year ends. For purposes of calculating the foreign effective tax rate, the foreign taxes taken into account are those taxes that, absent the proposal, would be eligible to be claimed as a foreign tax credit during the 60-month period. Additionally, subject to rules applicable to hybrid arrangements, the foreign earnings taken into account during the 60-month period would be determined pursuant to US tax principles; however, such foreign earnings would include disregarded payments deductible elsewhere, such as disregarded intra-CFC interest or royalties, and would exclude dividends from related parties.

Under President Obama's proposal, the country to which foreign earnings and associated foreign taxes are assigned is based on tax residence under foreign law. The earnings and taxes of a particular CFC are permitted to be allocated to multiple countries if the CFC has earnings subject to tax in different countries. In such instances, the earnings and all of the applicable foreign taxes would be assigned to the country with the highest tax. Moreover, in cases where a foreign country's tax laws essentially render a CFC stateless so that it is not subject to foreign tax in any jurisdiction, the CFC's earnings would be subject to the full 19% tax rate.

To calculate the minimum tax for a particular country, the Budget proposes multiplying the applicable residual minimum tax rate by the minimum tax base for that country. For US corporations, the tentative minimum tax base for a particular country is the total amount of foreign earnings during the taxable year that are assigned to that country for purposes of determining the effective tax rate for the country.

The tentative minimum tax base would then be reduced by an allowance for corporate equity (ACE). According to the Administration, the ACE allowance would provide a "risk-free return" on equity invested in active assets, which generally would include assets that do not generate foreign personal holding company income. In essence, the ACE allowance is intended to exempt from the minimum tax a return on the actual activities carried out in a foreign country.

In assigning earnings to countries, both for purposes of determining the foreign effective tax rate and for determining the tentative minimum tax base for a particular year, the Budget contemplates rules to restrict the use of hybrid arrangements to shift earnings from a low-tax country to a high-tax country for US tax purposes without triggering taxation in the high-tax country.

The Budget would impose the minimum tax on current foreign earnings regardless of whether they are repatriated to the United States. Moreover, all foreign earnings could be repatriated without being subject to further US taxation. As such, and as made possible in part by the 14% one-time tax (discussed below), US tax would be imposed on a CFC's earnings either immediately (under subpart F or the minimum tax) or not at all (if the income was subject to sufficient foreign tax or was exempt pursuant to the ACE allowance). Additionally, subpart F generally would continue to require a US shareholder of a CFC to include in its gross income, on a current basis and at the full US tax rate (with foreign tax credits available as provided under current law), its share of the CFC's subpart F income; however, the subpart F high-tax exception would be made mandatory for US shareholders that are US corporations.

Further, the Budget would not impose US tax on a US shareholder's sale of stock of a CFC to the extent any gain reflects the undistributed earnings of the CFC, which generally would have already been subject to tax under the minimum tax, subpart F, or the 14% one-time tax. To avoid influencing a US shareholder's decision whether to sell CFC stock, any stock gain that is attributable to unrealized gain in the CFC's assets would be subject to US tax in the same manner as would apply to the future earnings from such assets. As such, stock gain would be subject to the minimum tax or to a tax that is equivalent to the full US rate to the extent it reflects unrealized appreciation in assets that would generate earnings subject to the minimum tax or subpart F, respectively.

The Administration proposes to continue taxing foreign-source royalty and interest payments received by US corporations at the full US statutory rate; however, in contrast with current law, foreign-source royalty and interest payments would not be affected by excess foreign tax credits associated with dividends from high-tax CFCs, as the earnings of high-tax CFCs would be exempt from US tax. The Budget would treat a foreign branch of a US corporation like a CFC. Therefore, to the extent the foreign branch used the intangibles of its owner, it would be treated as making royalty payments to its owner, which are recognized for US tax purposes. Interest expense incurred by a US corporation that is allocated and apportioned to foreign earnings on which the minimum tax is paid would be deductible at the residual minimum tax rate applicable to those earnings. The Budget does not permit a deduction for interest expense allocated and apportioned to foreign earnings for which no US income tax is paid. Moreover, the Budget proposes repealing rules regarding both CFC investments in US property and previously taxed earnings for US shareholders that are US corporations.

The Budget would grant the Treasury Secretary authority to issue regulations to implement and carry out the minimum tax, including through regulations addressing the taxation of undistributed earnings in instances where a US corporation owns an interest in a foreign corporation that has a change in status as a CFC or non-CFC, as well as regulations to prevent the avoidance of the purposes of the minimum tax through outbound transfers of built-in-gain assets or CFC stock.

This proposal would raise approximately US$205.98 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

### Impose a 14% One-Time Tax on Previously Untaxed Foreign Income.

In addition to the 19% minimum tax on foreign income, the Budget proposes a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to US tax. The Budget would provide a credit for the amount of foreign taxes associated with such earnings multiplied by the ratio of the one-time tax rate to the maximum US corporate tax rate for tax year 2015. The accumulated income subject to the one-time tax could then be repatriated without any further US tax. The Budget would use the additional revenue from this one-time tax to pay for: (1) new spending associated with the Administration's surface transportation reauthorization proposal; and (2) shortfalls between revenue and surface transportation spending that exist under current law for the proposal period.

This proposal would raise approximately US$268.13 billion over 10 years and would be effective on the date of enactment and apply to earnings accumulated for taxable years beginning before January 1, 2016. The tax would be payable ratably over five years.

### Impose a Financial Fee.

The Budget includes a proposal to assess a seven-basis-point fee on certain liabilities of large financial firms. The fee would apply to both domestic and foreign banks, as well as to bank holding companies and "nonbanks," such as insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. US subsidiaries and branches of foreign entities that fall into these business categories and that have assets in excess of US$50 billion also would be covered. Firms are not subject to the fee during periods when their worldwide consolidated assets are less than US$50 billion. The fee would apply to a financial entity's covered liabilities, which are assets less equity for banks and nonbanks based on audited financial statements with a deduction for separate accounts. The fee would be deductible in computing corporate income tax. The fee would be reported on annual federal income tax returns. Firms would make estimated payments of the fee on the same schedule as estimated income tax payments.

This proposal would raise approximately US$111.81 billion over 10 years and would be effective as of January 1, 2016.

## Reform the Taxation of Capital Income.

The Administration proposes to increase the highest long-term capital gains and qualified dividend tax rate from 20% to 24.2%. When added to the 3.8% net investment income tax, the maximum total capital gains and dividend tax rate would rise to 28%.

The Budget would generally treat transfers of appreciated property as a sale of the property. The donor or deceased owner of an appreciated asset would realize a capital gain at the time the asset is given or bequeathed to another, with the amount of the gain realized being equal to the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. That gain would be taxable income to the donor in the year the transfer was made, and to the decedent either on the final individual return or on a separate capital gains return. Additionally, the Budget provides for the unlimited use of capital losses and carry-forwards against ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate, if any. Gain would not be recognized on gifts or bequests to a spouse or to charity. Instead, the basis of the donor or decedent would carry over to a spouse and gain recognition would be deferred until the spouse disposes of the asset or dies. Appreciated property donated or bequeathed to charity would be exempt from capital gains tax.

The Budget would exempt any gain on tangible personal property (excluding collectibles). Additionally, the Administration is proposing to allow a US$100,000 per person exclusion of other capital gains recognized by reason of death, which would be indexed for inflation after 2016 and be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes – thus effectively making the exclusion US$200,000 per couple. The Budget would maintain the current exclusion of US$250,000 per person for capital gain on a principal residence, which would be portable to the decedent's surviving spouse – thus effectively making the exclusion US$500,000 per couple.

The Administration would maintain the exclusion under current law for capital gain on certain small business stock. Additionally, payment of tax on the appreciation of certain small family-owned and operated businesses would not be due until the business is sold or ceases to be family-owned and operated. The Budget provides for a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets.

The Budget proposes other legislative changes designed to facilitate and implement this proposal, including: (1) the allowance of a deduction for the full cost of appraisals of appreciated assets; (2) the imposition of liens; (3) the waiver of penalty for underpayment of estimated tax if the underpayment is attributable to unrealized gains at death; (4) the grant of a right of recovery of the tax on unrealized gains; (5) rules to determine who has the right to select the return filed; (6) the achievement of consistency in valuation for transfer and income tax purposes; and (7) a broad grant of regulatory authority to provide implementing rules. The Budget would provide the Treasury Secretary with the authority to issue any regulations necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete are unavailable.

This proposal would raise approximately US$207.88 billion over 10 years and would be effective for capital gains realized and qualified dividends received in taxable years beginning after December 31, 2015, and for gains on gifts made and of decedents dying after December 31, 2015.

## Limit the Ability of Domestic Entities to Expatriate.

As part of the Budget, the Administration is seeking to limit the ability of domestic entities to expatriate by broadening the definition of an inversion transaction by changing the 80% test to a greater than 50% test, and eliminating the 60% test. The Budget would add a special rule whereby, regardless of the level of shareholder continuity, an inversion transaction would occur if: (1) immediately prior to the acquisition, the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation; (2) the expanded affiliated group that includes the foreign acquiring corporation (EAG) is primarily managed and controlled in the United States; and (3) the EAG does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. Additionally, the Budget would expand the scope of acquisitions described in section 7874 of the Code so that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the assets of a domestic corporation or domestic partnership, substantially all of the trade or business assets of a domestic corporation or domestic partnership, or substantially all of the US trade or business assets of a foreign partnership.

The Budget would provide the IRS with authority to share tax return information with federal agencies for the purpose of administering anti-inversion rules. Those federal agencies receiving such information would be subject to the safeguarding and recordkeeping requirements set forth by section 6103.

This proposal would raise approximately US$12.75 billion over 10 years and would limit the ability of domestic entities to expatriate effective for transactions that are completed after December 31, 2015.

### Restore the Estate, Gift and Generation-Skipping Transfer (GST) Tax Parameters in Effect in 2009.

The Budget would make permanent the estate, GST and gift tax parameters as they applied in 2009. Specifically, the top tax rate would be 45%, with an exclusion amount of US$3.5 million for estate and GST taxes, and of US$1 million for gift taxes, with no indexing for inflation. In computing gift and estate tax liabilities, no estate or gift tax would be incurred by reason of decreases in the applicable exclusion amount with respect to a prior gift that was excluded from tax at the time of the transfer. The unused estate and gift tax exclusion of a decedent electing portability and dying on or after the effective date of the proposal would be available to the decedent's surviving spouse in full upon the surviving spouse's death, but would be limited during the surviving spouse's life to the amount of remaining exemption the decedent could have applied to his or her gifts made in the year of his or her death.

This proposal would raise approximately US$189.31 billion and would be effective for the estates of decedents dying, and for transfers made, after December 31, 2015.

### Repeal FICA Tip Tax Credit.

The proposal would repeal the FICA tip tax credit that is available only for FICA tax paid on tips received in connection with providing, delivering or serving food or beverages for consumption. The repeal would be effective for taxable years beginning after December 31, 2015, and would raise approximately US$12.33 billion over 10 years.

### Repeal Tax-Exempt Bond Financing on Professional Sports Facilities.

The Budget would eliminate the private security or payment test for state or local governmental bonds issued to finance or refinance professional sports facilities, which would generally mean that such bonds would be taxable private activity bonds if more than 10% of the bond-financed facility is used for private business use. The elimination of the private security or payment test for state or local governmental bonds issued to finance or refinance professional sports facilities would apply to such bonds issued after December 31, 2015.

The proposal would raise approximately US$542 million over 10 years.

### Repeal Preferential Dividend Rule for Publicly Traded and Publicly Offered Real Estate Investment Trusts (REITs).

The Budget proposes repealing the preferential dividend rule for publicly traded REITs and publicly offered REITs. The proposal would also provide the Treasury Secretary with explicit authority to cure inadvertent violations of the preferential dividend rule where it continues to apply and, where appropriate, to require consistent treatment of shareholders. The proposal has a negligible revenue effect and would apply to distributions that are made (without regard to section 858) in taxable years beginning after the date of enactment.

## New Tax Reductions

### Repeal Delay in the Implementation of Worldwide Income Allocation.

The American Jobs Creation Act of 2004 modified the interest expense allocation rules by provide a one-time election under which the taxable income of the domestic members of an affiliated group from sources outside the United States generally would be determined by allocating and apportioning interest expense of the domestic members on a worldwide group basis. Subsequent legislation deferred the availability of the election to taxable years beginning after December 31, 2020. The proposal would make the election available for taxable years beginning after December 31, 2015. This proposed change is related to the proposed 19% minimum tax proposal, discussed above.

The proposal would cost approximately US$12.21 billion over ten years (presumably determined after taking into account the 19% minimum tax).

### Establish a Uniform Definition of Small Business for Accounting Methods.

The Budget would establish a uniform small business threshold of US$25 million in average annual gross receipts for allowing exceptions from certain accounting rules. The threshold would be indexed for inflation. All entities treated as a single employer under existing law would be treated as a single entity for purposes of applying the threshold. Entities that are below the threshold could elect (i) to use the cash method in lieu of the accrual method, (ii) the non-application of the uniform capitalization rules, and (iii) use of an inventory method that either conforms to the taxpayer's financial accounting method or is otherwise properly reflective of income. As a general rule, a business whose average annual gross receipts for the preceding three years exceeds the threshold would not be able to make an election to use these simplified methods for the current taxable year and the following four taxable years. Notably, these rules would supersede the special cash method exception that applies to farm corporations, but exceptions allowing personal service corporations and business entities that are not C corporations (and do not have C corporation partners) to use the cash method, regardless of the size of the entity, would survive. The UNICAP farming exceptions would survive, but would be affected by the new gross receipts threshold for excepting UNICAP requirements altogether for produced property, as well as by the higher threshold for requiring use of an accrual accounting method.

The proposal would cost approximately US$14.76 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

## Provide a Second-Earner Tax Credit.

The Budget includes a proposal to provide two-earner married couples who file as married-filing-jointly with a nonrefundable tax credit equal to a percentage of the lower earner's earned income up to US$10,000, including wages and net earnings from self-employment. The maximum credit rate would be 5% and would be phased down at a rate of one-half of a percentage point for every US$10,000 of adjusted gross income (AGI) over $120,000, with a maximum credit of US$500 that would be fully phased out at AGI over $210,000. The maximum creditable earned income and the AGI at which the credit rate starts to phase down would be indexed for inflation after 2016.

The proposal would cost approximately US$89.03 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

## Expand the Earned Income Tax Credit (EITC) for Workers Without Qualifying Children and Simplifying the Rules for Claiming the EITC for Workers Without Qualifying Children.

The Administration is proposing to increase the EITC for workers without qualifying children by doubling the phase-in rate and the phase-out rate from 7.65% to 15.3%, thereby doubling the maximum credit from approximately US$500 to approximately US$1,000. The Budget would increase the beginning of the phase-out range from an estimated US$8,350 to US$11,500 for 2016 (from US$13,940 to US$17,090 for joint filers) and index the range for inflation in subsequent years. The credit for workers without qualifying children would be phased out completely at US$18,173 for single taxpayers and US$23,763 for married taxpayers filing jointly.

The Budget expands the age for eligibility for the EITC for workers without qualifying children from at least 25 and less than 65 to at least 21 and less than 67. As under current law, taxpayers who could be claimed as a qualifying child or a dependent would not be eligible for the EITC for childless workers.

The proposal would cost approximately US$59.94 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

Separately, the Administration is proposing to simplify the EITC rules by allowing certain taxpayers who reside with a qualifying child that they do not claim as qualifying children to receive the EITC for workers without qualifying children. The proposal would cost approximately US$5.65 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

## Reforming Child Care Tax Incentives.

The Budget proposes repealing dependent care flexible spending accounts, increasing the child and dependent care credit, and creating a larger credit for taxpayers with children under the age of five. The proposal would increase the income level at which the credit under current law begins to phase down from US$15,000 to US$120,000, such that the rate reaches 20% at income levels above $148,000. Taxpayers with young children could claim a child care credit of up to 50% of expenses up to US$6,000 (US$12,000 for two young children). The Budget proposes phasing down the credit rate for the young child credit at a rate of one percentage point for every US$2,000 (or part thereof) of AGI $120,000 until the rate reaches 20% for taxpayers with incomes above $178,000. The proposal would index for inflation the expense limits and income at which the credit rates begin to phase down after 2016.

The proposal would cost approximately US$49.87 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

## Simplify and Better Target Tax Benefits for Education.

### Expand and Modify the AOTC and Repeal Lifetime Learning Credits

In an effort to further increase tax benefits available to students while they are in college and simplify the claiming of tax benefits, the Budget would replace the Lifetime Learning Credit and student loan interest deduction with an expanded AOTC, which would be available for the first five years of postsecondary education and for five tax years. It would expand eligibility to include less than half-time undergraduate students, simplify and increase the refundable portion of the AOTC, and index expense limits and the refundable amount for inflation after 2016.

The AOTC would be available to students attending school at least half-time in an amount equal to 100% of the first US$2,000 of eligible expenses and 25% of the next US$2,000 of eligible expenses, with the first US$1,500 being refundable. Eligible students attending school less than half-time would be able to claim a part-time AOTC equal to 50% of the first US$2,000 of eligible expenses plus 12.5% of the next US$2,000 of eligible expenses, with the first US$750 being refundable.

Under the Budget, students who can be claimed as a dependent on someone else's tax return would no longer be able claim the nonrefundable portion of the AOTC on their own return.

The proposal would cost approximately US$31.29 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

### Make Pell Grants Excludable from Income

The Budget would attempt to further simplify education benefits for low-income students by excluding all Pell Grants from gross income and from the AOTC calculation.

The proposal would cost approximately US$17.56 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

### Modify Reporting of Tuition Expenses and Scholarships on Form 1098-T

The Budget would require institutions of higher education to report amounts paid, not billed, on Form 1098-T, as well as require any entity issuing a scholarship or grant in excess of US$500 – which amount would be indexed for inflation after 2016 – that is not processed or administered by an institution of higher education to report the scholarship or grant on Form 1098-T.

The proposal would raise approximately US$618 million over 10 years and would be effective for taxable years beginning after December 31, 2015.

### Repeal the Student Loan Interest Deduction and Provide Exclusion for Certain Debt Relief and Scholarships

The Administration is proposing four changes to the tax rules governing student loans. Specifically, the proposal would: (1) repeal the deduction for student loan interest for new students; (2) conform the tax treatment of loan amounts repaid by Indian Health Service (IHS) to the tax treatment of loan amounts paid by National Health Service Corps (NHSC) and certain state programs intended to increase the availability of health care services to underserved populations; (3) conform the tax treatment of IHS Health Professions Scholarships to the tax treatment of NHSC scholarships and Armed Forces Health Professions (AFHP) scholarships; and (4) allow the Treasury Secretary to disclose identifying information to the Department of Education for the purpose of contacting late-stage delinquent borrowers to inform them about options for avoiding default, while also allowing the Department of Education to re-disclose this information, as under current law for defaulted borrowers, to certain lenders, guarantee agencies, and educational institutions for this purpose.

The proposal would raise approximately US$1.25 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

### Repeal Coverdells and Reduce the Federal Tax Benefits of Qualified Tuition Programs

The Budget proposes to repeal Coverdell Education Savings Accounts (ESAs) and reduce the federal tax benefits allowed to qualified tuition programs (529 plans) as part of an effort to help pay for the aforementioned education tax incentives. The Budget would not allow any new contributions to Coverdell ESAs. Moreover, while qualifying distributions of earnings on contributions to Coverdell and section 529 ESAs made prior to the date of enactment would continue to be excludable from gross income, distributions of earnings on contributions to section 529 ESAs made after the date of enactment would no longer be excludable from gross income, although they would still benefit from being includable only in the gross income of the student beneficiary, not the gross income of the account holder.

The proposal would raise approximately US$1.28 billion over 10 years and would be effective for taxable years beginning after December 31, 2015, except that the provisions regarding student loan forgiveness would be effective for discharges of loans after December 31, 2015, and the provisions expanding disclosure of taxpayer identifying information for late-stage delinquency would be effective upon enactment.

Notably, as mentioned above, President Obama does not plan to pursue his proposal to reduce the tax benefits associated with 529 plans.

## Provide for Automatic Enrollment in Individual Retirement Accounts or Annuities (IRAs), Including a Small Employer Tax Credit, and Double the Tax Credit for Small Employer Plan Start-Up Costs.

The Administration is proposing to require employers that have been in business for at least two years and that have more than 10 employees to offer an automatic IRA option to employees, under which regular contributions would be made to an IRA on a payroll-deduction basis. Under the Budget, if the employer sponsored a qualified retirement plan, SEP or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. However, if the qualified plan excluded from eligibility a portion of the employer's work force or a class of employees, the employer would be required to offer the automatic IRA option to those excluded employees.

The employer offering automatic IRAs would provide employees with a standard notice and election form and allow them to elect to participate or opt out. Any employee who fails to provide a written participation election would be enrolled at a default rate of three percent of the employee's compensation in an IRA. Employees could opt out or opt for a lower or higher contribution rate up to the IRA dollar limits. Moreover, the Budget would let employees choose either a traditional IRA or a Roth IRA, with Roth IRAs being the default.

At the employer's option, payroll-deduction contributions from all participating employees could be transferred to a single private-sector IRA trustee or custodian designated by the employer. Alternatively, if the employer prefers, it could allow each participating employee to designate the IRA provider for that employee's contributions or could designate that all contributions be forwarded to a savings vehicle specified by statute or regulation.

Under the Budget, there would be no need for employers making payroll deduction IRAs available to choose or arrange default investments, as a low-cost, standard type of default investment and a handful of standard, low-cost investment alternatives would be prescribed by statute or regulation. Moreover, this approach would not involve employer contributions, employer compliance with qualified plan requirements, or employer liability or responsibility for determining employee eligibility to make tax-favored IRA contributions or for opening IRAs for employees. Information and basic educational material regarding saving and investing for retirement, including IRA eligibility, would be made available online; however, as under current law, individuals would bear ultimate responsibility for determining their IRA eligibility.

Contributions by employees to automatic IRAs would qualify for the saver's credit to the extent the contributor and the contributions otherwise qualified.

Small employers (i.e., those with fewer than 100 employees) that offer an automatic IRA arrangement would be eligible to claim a temporary non-refundable tax credit for the employer's expenses associated with the arrangement up to US$500 for the first year and US$250 for the second year, and would also be entitled to an additional non-refundable credit of US$25 per enrolled employee up to US$250 for six years.

In an effort to encourage employers not currently sponsoring a qualified retirement plan, SEP or SIMPLE to do so, and in conjunction with the automatic IRA proposal, the Budget would double the non-refundable "start-up costs" tax credit to a maximum of US$1,000 per year for three years for a small employer that adopts a new qualified retirement, SEP or SIMPLE. Moreover, the credit would be extended from three to four years for any employer that adopts a new qualified retirement plan, SEP or SIMPLE during the three years beginning when it first offers – or first is required to offer – an automatic IRA arrangement. This expanded credit would not apply to automatic or other payroll deduction IRAs and would thus encourage small employers to adopt a new 401(k), SIMPLE or other employer plan instead.

The proposal would cost approximately US$17.12 billion over 10 years and would be effective for taxable years beginning after December 31, 2015.

## Bond Programs.

Acknowledging the important role of the private sector in public infrastructure investment, the Budget proposes establishing of a new category of tax-exempt Qualified Public Infrastructure Bonds (QPIBs) for projects owned by state or local governments and that are available for general public use. Further, the Budget would create a new, expanded and permanent America Fast Forward Bond (AFFB) program as an optional alternative to traditional tax-exempt bonds. The Budget would permanently expand the qualified small issuer limit in the definition of qualified tax-exempt obligations to include issuers of up to US$30 million of tax-exempt bonds annually.

For more information about these and other bond initiatives, please refer to the "Transportation" section of our firm's Budget analysis.

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