Tax provisions in the administration’s FY 2014 Budget

The Obama Administration’s FY 2014 budget, transmitted to Congress by the White House on April 10, represents President Obama’s spending and revenue recommendations for the 2014 fiscal year, beginning on October 1, 2013. These will be considered as Congress attempts to resolve its own budget for spending and revenues.

The administration’s FY 2014 budget proposes:

- Spending cuts and revenue increases of $1.2 trillion over 10 years, to replace the spending cuts mandated by the Budget Control Act of 2011, also known as the “sequester”
- Deficit reduction of $1.8 trillion over 10 years
- A framework for revenue-neutral tax reform

Framework for revenue-neutral tax reform

The administration’s FY 2014 budget offers a detailed analysis of business proposals that “close loopholes and provide incentives for growth in a fiscally responsible manner.” The administration proposes that these measures be enacted as part of revenue-neutral tax reform. These proposals are not reflected in the budget receipts and are not counted towards deficit reduction.

The framework that the administration proposes contains the following five elements:

- Eliminate loopholes and subsidies, broaden the base, and cut the corporate tax rate (though no specific rate cut is proposed)
- Strengthen domestic manufacturing and innovation
- Strengthen the international tax system
- Simplify and cut taxes for small business
- Restore fiscal responsibility and not “add a dime to the deficit”

The president’s business tax reform proposal includes many of the proposals from previous budgets such as changes to the taxation of foreign income, energy provisions, and making the research credit permanent. The proposals include a few new incentives, such as a temporary 10% small business credit for new jobs and wage increases. Reform proposals also include changes to the taxation of financial derivatives, much as proposed by the Ways and Means Committee, such as a mark-to-market rule.

The reform proposals include a number of familiar revenue-raising provisions from previous budgets, such as a financial crisis responsibility fee imposed on financial institutions and changes to the taxation of carried interests in partnerships.

It is important to note that, unlike the administration’s previously published Framework for Business Tax Reform (February 2012), the budget does not contain a specific rate
reduction proposal nor does it reiterate a number of its previously suggested revenue offsets to finance the rate reduction. In particular, the budget makes no mention of previous proposals to eliminate accelerated depreciation, impose a minimum tax on income earned outside the United States, limit the deductibility of corporate interest, and expand the scope of the corporate tax to “large passthrough” entities.

Deficit reduction

The administration’s FY 2014 budget proposes an additional $1.8 trillion in deficit reduction over 10 years, of which just over $1 trillion would come from revenue (tax) increases.

New revenues of $580 billion would come from two individual income tax changes affecting high-income taxpayers:

- A new proposal would require households with incomes over $1 million to pay at least 30% of their income (after charitable giving) in taxes (the so-called “Buffett rule”).
- A proposal from previous budgets would limit the value of tax deductions and other tax benefits for high-income taxpayers to 28%.

The administration’s FY 2014 budget includes a new proposal that would reduce the deficit by $230 billion over 10 years by replacing the consumer price index (CPI) currently used for inflation with “chained CPI”—generally a lower measure of inflation. As a result, social security and other benefits would be reduced by $130 billion over 10 years; in addition, revenues would be increased by $100 billion from lower adjustments to tax brackets and other indexed provisions.

Another new proposal for deficit reduction is a limit on the amount that can be accumulated in tax-preferred retirement accounts. The proposal would limit the deduction or exclusion for contributions to tax-favored retirement plans, including IRAs, 401(k)s, and defined benefit plans when the amounts in those plans exceed a maximum allowable benefit, raising $9 billion over 10 years.

As in previous budgets, the administration’s FY 2014 budget includes many loophole closers, base broadeners, and simplification measures.

Resources

- The administration’s FY 2014 budget proposal
- General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals (the “Green Book”), available on the Treasury website.

In this report, $ = U.S. dollar, and % = percentage.
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FRAMEWORK FOR REVENUE-NEUTRAL BUSINESS TAX REFORM

INSOURCING, MANUFACTURING, RESEARCH, EMPLOYMENT, AND CLEAN ENERGY

Provide tax incentives for locating jobs and business activity in the United States and remove tax deductions for shipping jobs overseas

The administration’s FY 2014 proposal would create a new general business credit against income tax equal to 20% of the eligible expenses paid or incurred in connection with insourcing a U.S. trade or business, i.e., in connection with reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the creditable costs may be incurred by the foreign subsidiary of the U.S.-based multinational company, the tax credit would be claimed by the U.S. parent company. A similar benefit would be extended to “non-mirror Code possessions” (Puerto Rico and American Samoa) through compensating payments from the U.S. Treasury.

In addition, the proposal would disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business, i.e., in connection with reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In determining the subpart F income of a controlled foreign company (CFC), no reduction would be allowed for any expenses associated with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with insourcing or outsourcing a U.S. trade or business would be limited solely to expenses associated with the relocation of the trade or business and would not include capital expenditures or costs for severance pay and other assistance to displaced workers. The Secretary would be authorized to prescribe rules to implement the provision, including rules to determine covered expenses. The proposal would be effective for expenses paid or incurred after the date of enactment.

KPMG observation

Neither the tax credit nor the expense disallowance would apply unless there is an impact on U.S. jobs from the insourcing or outsourcing, respectively, of a U.S. trade or business. The proposal does not specify the required degree of such impact or ways to determine it. The proposal also does not specify the extent to which there must be a simultaneous impact on the foreign trade or business (and jobs). The proposal would allow a tax credit to the U.S. parent even if it does not incur the insourcing costs directly (i.e., if the costs are incurred by its foreign subsidiary). On the flip side, the proposal
may affect (increase) the amount of subpart F income at the level of a CFC associated with outsourcing of a U.S. trade or business.

**Provide new manufacturing communities tax credit**

The administration’s FY 2014 proposal would create a new allocated tax credit to support investments in communities that have suffered a major job loss event. For this purpose, a major job loss event occurs when a military base closes or a major employer closes or substantially reduces a facility or operating unit, resulting in a long-term mass layoff. Applicants for the credit would be required to consult with relevant state or local economic development agencies (or similar entities) in selecting those investments that qualify for the credit. The credit could be structured using the mechanism of the New Markets Tax Credit or as an allocated investment credit similar to the Qualifying Advanced Energy Project Credit. The proposal would provide about $2 billion in credits for qualified investments approved in each of the three years, 2014 through 2016.

**Enhance and make permanent the research tax credit**

The *American Taxpayer Relief Act of 2012* (ATRA), enacted on January 2, 2013, renewed the research credit for two years, through December 31, 2013.

ATRA effectuates two substantive changes to the credit, effective for tax years beginning after December 31, 2011, which are in regard to: (1) the treatment of an acquisition of a major portion of a trade or business; and (2) controlled group credit allocation methodology.

The overall credit percentage remains unchanged at 20% of qualified research expenses (QREs) over a base amount (determined by reference to a ratio of QREs to gross receipts in earlier years). Alternatively, a taxpayer can elect instead to use the alternative simplified credit (ASC), which is equal to 14% of qualified research expenses that exceed 50% of the average qualified research expenses for the three preceding tax years, without any reference to gross receipts.

**Note:** The ASC method may only be elected on a timely filed tax return (inclusive of extensions).

The administration’s FY 2014 proposal would make the research credit permanent and raise the rate of the alternative simplified credit to 17% from 14%, effective after December 31, 2012.

**KPMG observation**

The administration does not propose any substantive changes to the computation of the research credit.
Extend certain employment tax credits

The administration’s FY 2014 proposal would permanently extend the Work Opportunity Tax Credit (WOTC) to apply to wages paid to qualified individuals who begin work for the employer after December 31, 2013. The WOTC is currently available for employers hiring individuals from one or more of nine targeted groups (one of which is veterans) and is set to expire for such individuals who are hired after December 31, 2013.

The proposal would also permanently extend the Indian employment credit to apply to wages paid to qualified employees in tax years beginning after December 31, 2013. In addition, the proposal would modify the calculation of the Indian employment credit. For tax years beginning after December 31, 2013, the credit would be equal to 20% of the excess of qualified wages and health insurance costs paid or incurred by an employer in the current tax year over the amount of such wages and costs paid or incurred by the employer in the base year. The base year costs would equal the average of such wages and costs for the two tax years prior to the current tax year.

Provide a credit for advanced technology vehicles

The administration’s FY 2014 proposal would expand the types of alternative vehicles that are eligible for a tax credit.

Section 30D provides a credit for placing in service qualified plug-in electric drive motor vehicles. The maximum credit available for qualified vehicles is $7,500.

The administration’s FY 2014 proposal would replace the credit for plug-in electric drive motor vehicles with a credit for “advanced technology vehicles.” An advanced technology vehicle is a vehicle meeting the following criteria:

- The vehicle operates primarily on an alternative to petroleum;
- As of January 1, 2012, there were few vehicles in operation using the same technology as such vehicle; and
- The technology used by the vehicle exceeds the footprint-based target miles-per-gallon gasoline equivalent (MPGe) by at least 25%.

The credit would be limited to vehicles weighing no more than 14,000 pounds. Generally the credit would be the product of $5,000 and 100 and the amount by which the vehicle’s footprint gallons per mile exceeds its gallons per mile ($5,000 × 100 × (footprint gallons per mile minus gallons per mile)). The credit would be capped at $10,000 ($7,500 for vehicles with an MSRP above $45,000). The credit for a battery-powered vehicle would be determined under the current rules under section 30D if that computation results in a larger credit.

The administration’s FY 2104 proposal would allow the seller of the vehicle, rather than the vehicle owner, to claim the credit, though the amount of the credit must be disclosed to the purchaser.
The credit would be allowed for vehicles placed in service after 2013 and before January 1, 2021, though the credit would step down by 25% each year starting in 2018.

**Provide an alternative-fuel motor vehicle credit for medium- and heavy-duty alternative-fuel commercial vehicles**

The administration’s FY 2014 proposal would provide a tax credit for certain medium and heavy-duty weight vehicles that are powered by alternative fuels.

Section 30B provides credits for a taxpayer who places in service alternative motor vehicles. Currently, section 30B provides a credit for fuel-cell vehicles, and the credit is available for vehicles purchased before 2015. Section 30B also provides a credit for alternative-fuel motor vehicles; however, that credit expired in 2011.

The administration’s FY 2014 proposal would allow a tax credit for dedicated alternative fuel vehicles weighing more than 14,000 pounds (i.e., trucks and buses). The credit amount would be 50% of the incremental cost of such vehicle compared to the cost of a comparable diesel or gasoline vehicle. The credit would be capped at $25,000 for vehicles weighing up to 26,000 pounds and $40,000 for vehicles weighing more than 26,000 pounds. In the case of an alternative-fuel vehicle otherwise eligible for the current law fuel cell credit, a credit allowed under the proposed credit would be reduced by any amount of credit received under current law.

The credit would be allowed to the person placing the vehicle in service. In the case of a vehicle placed in service by certain tax-exempt or government entities, the credit would be allowed to the person that sold the vehicle to such entity (or at the election of the seller, to the person financing the sale), but only of the amount of the credit is disclosed to the purchaser.

The credit would be allowed for vehicles placed in service after 2013, and before 2020. For vehicles placed in service in calendar year 2019, the credit would be limited to 50% of the otherwise allowable amount.

**Modify and permanently extend renewable electricity production tax credit**

The administration’s FY 2014 proposal would expand existing federal income tax incentives for renewable energy projects.

Section 45 provides a production tax credit (PTC) for the production of electricity from wind energy at facilities that begin construction prior to 2014. It also provides a PTC for the production of electricity from biomass, geothermal, trash combustion, hydropower, landfill gas, and marine and hydrokinetic facilities if construction begins on the facility prior to 2014. The PTC is available for a 10-year period beginning with the date the facility is originally placed in service.
In addition, section 48 provides an investment tax credit (ITC) of up to 30% for energy credit property placed in service prior to 2017. Energy-credit property includes solar, geothermal, fuel cells, microturbines, combined heat and power, and small wind property. In addition, PTC-qualifying facilities may elect to claim the ITC instead of the PTC. In order to qualify for the ITC, such PTC-qualifying facilities must begin construction by their PTC mandated deadline (i.e., construction must begin before 2014).

The administration’s FY 2014 proposal would extend the PTC permanently and would make it refundable. The refundability portion of the proposal would be effective for projects that begin construction after 2013. The proposal would extend the PTC to solar energy property. The proposal would not make any changes to the ITC.

**KPMG observation**

By making the PTC refundable, the proposal would eliminate the need for renewable energy developers to obtain tax-equity financing. Tax-equity financing is a form of equity financing whereby a renewable energy developer seeks an outside investor that can efficiently utilize the tax credits. In a tax-equity transaction, the credits are specially allocated to the outside investor through the use of a partnership flip transaction.

**Modify and permanently extend the deduction for energy-efficient commercial building property**

Section 179D provides a deduction in an amount equal to the cost of “energy efficient commercial building property” placed in service during the tax year. The section 179D deduction is currently set to expire on December 31, 2013.

The administration’s FY 2014 proposal would increase both the maximum deduction and the partial deduction available for the installation of energy-efficient commercial building property.

The proposal would raise the current maximum deduction for energy-efficient commercial building property to $3.00 per square foot (from $1.80 per square foot). The maximum partial deduction allowed with respect to each separate building system would be increased to $1.00 per square foot (from $0.60 per square foot).

For taxpayers that simultaneously satisfy the energy savings targets for both building envelope and heating, cooling, ventilation, and hot water systems, the proposal would increase the maximum partial deduction to $2.20 per square foot (from $1.20 per square foot). Energy-savings targets would be updated every three years by the Secretary of Treasury in consultation with the Secretary of Energy to encourage innovation by the commercial building industry.

The proposal also would provide a new deduction based on a combination of the projected and realized energy savings performance achieved by a plan to retrofit
existing commercial buildings. The deduction would only be applicable to existing buildings with at least 10 years of occupancy. The deduction would be capped at 50% of the total cost of implementing the plan. The deduction would be allowed on a sliding scale ranging from $1.00 per square foot of retrofit floor area, for energy savings of at least 20%, up to $4.00 per square foot of retrofit floor area, for energy savings of 50% or more. Sixty percent (60%) of the deduction would be available when the property is placed in service and would be based on the projected energy savings performance of the commercial building retrofit plan. The remaining 40% of the allowable deduction would be available at a later point and would be based on actual energy savings performance of the retrofit plan. Actual energy savings would be based on the energy usage of the commercial building after the retrofit plan is complete, as determined by methods and procedures provided by Secretary of Treasury in consultation with Secretary of Energy.

Special rules would be provided to allow the credit to benefit a real estate investment trust or its shareholders.

A taxpayer could only take one deduction for each commercial building property.

The new deduction would be permanent and would be available for property placed in service after 2013.

**KPMG observation**

By increasing the basic deduction from $1.80 to $3.00, the proposal would substantially enhance the incentive for taxpayers.

**KPMG observation**

The administration’s FY 2014 proposal does not intend to extend certain provisions that are set to expire, including: the 50% additional first-year depreciation deduction; the 15-year recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvements; subpart F active financing and section 954(c)(6) look-through exceptions.

**SMALL BUSINESS**

**Extend increased expensing of qualifying depreciable property**

The administration’s FY 2014 proposal would make permanent the 2013 increased expensing and investment limitations under section 179. Under current law, 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 2013 tax years, the maximum deduction amount was $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 2013, the limits will revert to pre-2003 law, with $25,000 as the maximum deduction and $200,000 as the beginning of the phase-out range. The amount allowable as a deduction for any tax year cannot exceed the taxable income that is derived from the active conduct of a trade or business, and generally any disallowed deduction can be carried forward to the following tax year.

Qualifying property is generally depreciable tangible personal property that is purchased for use in the active conduct of a trade or business (including off-the-shelf computer software for tax years beginning after 2002 and before 2014). For tax years 2010 through 2013, qualifying property also includes certain real property, such as leasehold improvement property, restaurant property, and retail improvement property – however, the maximum amount of cost of such property that may be expensed is $250,000.

The proposal would permanently extend the increased expensing and investment limitations of $500,000 and $2 million, respectively, and the limits would be indexed for inflation for all tax years beginning after 2013. 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.

**Permanently exclude gain on the sale of certain small business stock from income of non-corporate taxpayers**

The administration’s FY 2014 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, 2013, 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, and
- 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 proposal to permanently adopt the complete exclusion would be effective for stock issued after December 31, 2013. The proposal would also eliminate the AMT preference item for gain excluded under the provision and impose additional reporting requirements.

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 2014 proposal would extend this time limit to six months for qualified small business stock the taxpayer has held longer than three years.

**Permanently reinstate increased amount of deductible start-up 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 2014 proposal would reinstate the increase from the 2010 legislation on a permanent basis, effective for tax years ending on or after the date of enactment.

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 which 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.

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 (but not below zero) 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.

The administration’s FY 2014 proposal would permanently adopt the changes made by the 2010 legislation, but on a going-forward basis. The administration believes that a permanent doubling of currently deductible start-up expenses will provide a stimulus to business formation and job creation.

**KPMG observation**

Because the proposal would be effective for tax years ending on or after the date of enactment and because the previous exception applied only to tax years beginning in 2010, the proposal would apparently leave tax years that began in 2011 and 2012 subject to the $5,000 and $60,000 limits.
Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance

The Affordable Care Act of 2010 created a tax credit designed to help small employers provide health insurance for their employees and their employees’ families. To qualify for the credit, an employer must make uniform contributions of at least 50% of the premium. A qualified employer is one with no more than 25 full-time equivalent employees during the tax year and whose employees have annual full-time equivalent wages that average no more than $50,000 (indexed for inflation beginning in 2014.)

The credit is phased out on a sliding scale for employers with between 10 and 25 full-time equivalent employees, and also for average annual wages between $25,000 and $50,000 (these amounts are indexed for inflation.)

The administration’s FY 2014 proposal would expand the group of employers that are eligible for the 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 as between the number of employees and the average age 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 “state average premium.”

The provision would be effective for tax years beginning after December 31, 2012.

REGIONAL GROWTH

Extend and modify 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, 2013.

The administration’s FY 2014 proposal would make the NMTC permanent, with an allocation amount of $5 billion for each round. The administration estimates that $250 million per round will support financing healthy food options in distressed communities as part of the “healthy food financing initiative.” In addition, the administration’s FY
2014 proposal would permit NMTC amounts resulting from QEIs made after December 31, 2012, to offset alternative minimum tax (AMT) liability.

**Restructure assistance to New York City—provide tax incentives for transportation infrastructure**

Following the terrorist attacks of September 11, 2001, a defined area of Manhattan in New York City (known as the “New York Liberty Zone”) received various tax incentives. Authorization for these incentives has expired.

The administration’s FY 2014 proposal would provide tax credits to New York State and New York City for expenditures related to the construction or improvement of the transportation infrastructure in or connecting to the New York Liberty Zone, effective after December 31, 2013. The credit would be allowed in each year from 2014 through 2023, inclusive, subject to an annual limit of $200 million, and would be divided evenly between the state and the city. The credit would be allowed against any payments (other than payments of excise taxes and social security and Medicare payroll taxes) made by New York City and New York State under any provision of the Code, including income tax withholding.

**Modify tax-exempt bonds for Indian tribal governments**

Section 7871(c) generally restricts the authority of Indian tribal governments to issue tax-exempt bonds by limiting them to the financing of “essential governmental function” activities that are “customarily” performed by state and local governments with general taxing powers. The *American Recovery and Reinvestment Act of 2009* (ARRA) provided $2 billion in bond authority for a new category of Indian tribal government tax-exempt bonds known as “Tribal Economic Development Bonds.” This authority, in section 7871(f), generally permits use of tax-exempt bond financing under standards that are comparable to those applied to state and local governments. ARRA also directed Treasury to study the Tribal Economic Development Bond provisions and report recommendations. Treasury issued its report in December 2011. The proposal follows the recommendations.

Under the administration’s FY 2014 proposal, Indian tribal governments would be permitted to issue governmental bonds and private activity bonds under standards comparable to those applicable to state and local governments. The proposal would retain the existing location restriction, which requires that financed projects be located on Indian reservations. It would also retain the prohibition on financing certain gaming projects.

The provision would be effective as of the date of enactment.
Allow states to convert private activity bond volume cap into low-income housing tax credits (LIHTCs) that the state can allocate

For private activity bonds to be tax-exempt (i.e., to be “qualified private activity bonds”), the face amount of private activity bonds issued by the issuing authority in any state must not exceed the maximum amount of such bonds that the authority may issue for the year (PAB volume cap). Under the Code, a state is allowed a limited amount of PAB volume cap. Each year, a state is also provided with a limited amount of LIHTCs for the state to allocate among proposed low income housing projects.

Often, states are faced with more proposed low-income housing projects than their LIHTC allocation can support. Increasing the amount of LIHTCs would allow deserving projects that would not otherwise be viable to go forward.

The administration’s FY 2014 proposal would allow a state to convert the PAB volume cap into an LIHTC allocation for a calendar year based on a conversion ratio reset each year and capped at 7% of the state’s PAB volume cap for that year.

The proposal would be effective with respect to the PAB volume cap to be received in, and additional LIHTC allocation authority received for, calendar years beginning after the date of enactment.

Encourage mixed-income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income

An investor in low-income rental housing can qualify for a low-income housing tax credit (LIHTC), generally for the first 10 years in which the housing project is in service, if the building meets various requirements. Currently under section 42(g), a building may qualify for the LIHTC if it meets one of two criteria: (1) at least 20% of the units must be rent restricted and occupied by tenants with income at or below 50% of area median income (AMI); or (2) at least 40% of the units must be rent restricted and occupied by tenants with incomes at or below 60% of AMI.

Similar to the administration’s FY 2013 proposal, the administration’s FY 2014 proposal would add a third criterion to allow taxpayers to qualify a building for the LIHTC. Under this new criterion, at least 40% of the units would have to be occupied by tenants with incomes that average no more than 60% of AMI. This would be effective for elections under section 42(g)(1) made after the date of enactment.

Change formulas for 70% and 30% LIHTC

The owner of rental housing occupied by tenants having incomes below specified levels may claim the LIHTC over a 10-year period. The credits earned each year generally depend on, among other things, a credit rate, called the “applicable percentage.” There are two applicable percentages—the 70% present value credit rate and the 30% present value credit rate.
Every year, each state receives a limited number of LIHTCs that it may allocate. The *Housing and Economic Recovery Act of 2008* provided a temporary minimum applicable percentage of 9% for the 70% present value credit rate for buildings placed in service before December 31, 2013. This 9% rate was extended to credit allocations made before January 1, 2014.

The proposal would allow the 9% rate to expire at the end of 2013 and would increase the discount rate used in the present value calculation for allocated LIHTCs. The change would apply to both 70%- and 30%-allocated LIHTCs. Under the proposal, the discount rate to be used would be the average of the mid-term and long-term applicable federal rates for the relevant month, plus 200 basis points (although the 30% present value credit rate for LIHTCs that result from bond financing would continue to be computed under current law).

The proposal would be effective for allocations made after December 31, 2013.

**Add preservation of federally assisted affordable housing to allocation criteria**

Under current law, each state must adopt a qualified allocation plan to guide the allocation of LIHTCs. The Code requires 10 selection criteria to be included in every plan. The administration’s FY 2014 proposal would add preservation of federally assisted affordable housing as an eleventh selection criterion.

The proposal would be effective for allocations made in calendar years beginning after the date of enactment.

The provision would be effective for tax years of a REIT that end after the date of enactment.

**Make the LIHTC beneficial to real estate investment trusts (REITs)**

Under current law, a real estate investment trust (REIT) can be an investor in low-income housing, but it would get no benefit from any LIHTC because it distributes its income to its shareholders and pays no income tax; there is no mechanism to pass the LIHTC directly through to the REIT’s shareholders.

The administration’s FY 2014 proposal would allow a REIT that receives LIHTCs to elect to treat a portion of its dividends as tax-exempt income to its shareholders. The designated portion could not exceed the quotient of the REIT’s LIHTCs for the year, divided by the highest corporate income tax rate. If earnings and profits are insufficient to pay this amount as dividends, the unused authority to designate tax-exempt dividends could be carried forward indefinitely. If a REIT shareholder is itself a REIT, or a regulated investment company, it could pass the tax-exempt dividend on to its own shareholders, retaining the tax-exempt nature. The passive-loss limitations and at-risk rules would not apply to the receipt of the exempt dividends.
The provision would be effective for tax years of a REIT that end after the date of enactment.

INTERNATIONAL

Defer deduction of interest expense related to deferred income of foreign subsidiaries

The administration’s FY 2014 proposal would defer the deduction of an interest expense that is properly allocated and apportioned to stock of a foreign subsidiary that exceeds an amount proportionate to the taxpayer’s pro rata share of income from such subsidiary that is currently subject to U.S. tax.

Under the proposal, foreign-source income earned by a taxpayer through a branch would be considered currently subject to U.S. tax; thus, the proposal would not apply to an interest expense properly allocated and apportioned to such income. Other directly earned foreign source income (for example, royalty income) would be similarly treated. The amount of a taxpayer’s interest expense properly allocated and apportioned to stock of a foreign corporation generally would be determined under the principles of current Treasury regulations, but the proposal states that the Treasury Department would revise the existing regulations and propose such other statutory changes as necessary to prevent inappropriate decreases in the amount of interest expense allocated and apportioned to foreign source income.

Under the administration’s FY 2014 proposal, a deduction for deferred interest expense would be allowable in a subsequent tax year to the extent that the amount of interest expense allocated and apportioned to stock of foreign subsidiaries in such subsequent year is less than the annual limitation for that year.

KPMG observation

For corporations with high U.S. debt loads and/or a heavy allocation of interest expense to foreign subsidiary stock, the administration’s proposal may be viewed as an indirect, partial repeal of the deferral of U.S. tax on a foreign subsidiary’s income insofar as the proposal would compel the repatriation of otherwise deferred earnings in order for U.S. shareholders to obtain foreign-related interest deductions.

The JCT explanation of the administration’s FY 2013 proposal\(^1\) analyzes in detail the fundamental tax policy arguments for and against the deferral proposal as set out by the administration, including the impact on the matching principle, on investment decisions

\(^1\) Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal* ([JCS-2-2012](#)), June 2012.
by taxpayers, the parity of treatment between U.S. multinationals and their foreign counterparts, and the choice of tax residence for taxpayers. It also describes at length many of the unanswered technical issues raised by the FY 2013 proposal.

Many such issues remain under the FY 2014 proposal, including:

- Whether the proposal “overcorrects” and over-allotates interest expense to foreign source income because of the delay in the effective date of the worldwide interest allocation rules to 2021
- How to handle intra-group transactions and whether currency translation rules are needed in computing foreign source income on which U.S. tax is deferred
- Whether the earnings of entities below the sixth tier that are not included in the section 902 qualified group should be excluded from the computation of foreign source income on which U.S. tax is deferred

Finally, the JCT explanation observes that the administration’s FY 2013 proposal requiring deferred expense deductions would pose significant increased tax reporting and compliance burdens for all U.S. multinationals, requiring the collection and analysis of additional information that has not previously been necessary to track.

**Determine the foreign tax credit on a pooling basis**

The administration’s FY 2014 proposal includes changes to the foreign tax credit system. Under the proposal, a U.S. corporation would determine its section 902 “deemed paid” foreign tax credit on a consolidated basis taking into account the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed-paid foreign tax credit. The deemed-paid foreign tax credit for a tax year would be limited to an amount proportionate to the taxpayer’s pro rata share of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that tax year that are currently subject to U.S. tax. Foreign taxes deferred under this proposal in prior years would be creditable in a subsequent tax year to the extent that the amount of deemed paid foreign taxes in the current year is less than the annual limitation for that year.

**KPMG observation**

The administration’s FY 2014 proposal would limit the ability of U.S. corporations to enhance their foreign tax credit position by choosing to repatriate earnings from foreign subsidiaries that are subject to relatively high rates of foreign tax, while deferring the repatriation of active business earnings in other foreign subsidiaries subject to relatively low rates of foreign tax.

The JCT explanation of the administration’s FY 2013 proposal\(^2\) points out that significant planning opportunities remain that would allow taxpayers to avoid the

intended effects of the proposal. For example, high-taxed foreign earnings could be removed from the blending regime by converting foreign subsidiaries located in high-tax jurisdictions into first-tier branches or partnerships. It also identifies many associated technical complexities. For example, as with the deduction deferral proposal, the JCT explanation questions whether the pools of foreign subsidiary earnings must be determined on a consolidated basis, with elimination of the effects of intercompany transactions, or as the sum of separately computed company results.

Another issue identified by the JCT explanation to the FY 2013 proposal is how the proposal interacts with the present law section 904 limitation. Specifically, it is unclear the extent to which the proposal would apply to further reduce a U.S. taxpayer's allowable foreign tax credit that is already limited under section 904.

Likewise, it remains unclear how this proposal would interact with the foreign tax credit provisions enacted in 2010. Section 909, for example, may apply to suspend taxes in an upper-tier controlled foreign corporation (CFC) until the lower-tier CFC’s earnings are distributed. If the section 902 credit on a distribution from either CFC is computed based on combined earnings and taxes pools, there does not seem to be a good reason for suspending section 902 taxes, although section 909 would still be needed to prevent the splitting of section 901 taxes and related earnings. Section 960(c) (the “anti-hopscotch rule”) also would not seem to be needed if worldwide pooling is adopted.

Tax currently excess returns associated with transfers of intangibles offshore

The administration’s FY 2014 proposal includes a provision relating to intangible property which provides that if a U.S. person transfers an intangible asset from the United States to a related CFC, then certain excess income from the transaction would be treated as subpart F income if the income is subject to a low effective foreign tax rate (i.e., 10% or less, with a ratable phase out for effective foreign tax rates between 10% and 15%). The transfer of an intangible asset includes a sale, lease, license, shared risk, or development agreement. Excess intangible income would be defined as the excess of gross income from transactions connected with or benefitting from such intangible asset over the costs (excluding interest and taxes) properly allocated and apportioned to this income increased by a percentage mark-up. Subpart F income recognized under this proposal would be a separate category of income for purposes of determining the foreign tax credit limitation under section 904.

Limit shifting of income through intangible property transfers

The administration also proposes “clarifying” the definition of intangible property for purposes of sections 367(d) and 482 to include workforce-in-place, goodwill, and going-concern value. The administration’s FY 2014 proposal also provides that the IRS may value intangible property taking into consideration the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken, and when multiple intangible properties are transferred, the IRS
may value the intangible properties on an aggregate basis when that achieves a more reliable result.

**KPMG observation**

The proposal seems to intend to codify certain positions taken by the IRS under the temporary cost sharing regulations and in current taxpayer audits. Indeed, the JCT explanation of the administration’s FY 2013 proposal\(^3\) states that the proposal seeks to “[clarify] certain definitional and methodological issues that have arisen in controversies with respect to the value attributed to intangible property at the time it is transferred outside the United States.”

With respect to the definition of intangible property in particular, the JCT explanation states that the proposal would answer the question of whether the value attributable to goodwill, going-concern value, and workforce-in-place in outbound transfers to related parties requires compensation, and does so in a way that attempts to establish that the present law also requires compensation for such transfers.

The JCT explanation sets out a lengthy and detailed explanation of the challenges presented by aggregate versus item-by-item valuation and the development and interpretation of the “realistic alternative” principle. It also discusses at length whether the administration’s proposal is sufficient to address the problems it targets, and discusses various alternative approaches to accomplish the same or similar goals.

**Disallow the deduction for non-taxed reinsurance premiums paid to affiliates**

The administration’s FY 2014 proposal would: (1) deny an insurance company a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (2) exclude from the insurance company’s income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied.

A foreign corporation that receives a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat the premium and the associated investment income as income effectively connected with the conduct of a trade or business in the United States, and attributable to a permanent establishment for tax treaty purposes. The electing reinsurer would be subject to tax under section 842. For foreign tax credit purposes, however, reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

\(^3\) Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal* ([JCS-2-2012](http://www.jcs.gov/dockets/2012/20120620/)), June 2012.
The provision would be effective for policies issued in tax years beginning after December 31, 2013.

**KPMG observation**

Similar proposals have been made in the last few years. The “first dollar” disallowance of the U.S. company’s deduction for reinsurance premium paid is described as a deduction deferral mechanism, not a disallowance mechanism. The foregone deduction for reinsurance may or may not be fully offset by the exclusion of the associated ceding commission and / or reinsurance recoverable, and the timing of recovery of these items is uncertain. The proportionality rule would seem to indicate that 100% of ceding commissions and reinsurance recoverable may be excluded from the ceding company’s income—regardless of whether such amounts are less than, or exceed, the disallowed deduction for the reinsurance premium paid.

This provision was included in the administration’s 2012 and 2013 revenue proposals.

**Limit earnings stripping by expatriated entities**

The administration’s FY 2014 proposal would revise section 163(j) by tightening the limitation on the deductibility of interest paid by an “expatriated entity” to related persons.

Under the proposal, the current law debt-to-equity safe harbor would be eliminated, and the 50% adjusted taxable income threshold for the limitation would be reduced to 25%. The carryforward for disallowed interest would be limited to 10 years, and the carryforward of excess limitation would be eliminated.

An expatriated entity would be defined by applying the rules of section 7874 and the regulations thereunder as if section 7874 were applicable for tax years beginning after July 10, 1989. This special rule would not apply, however, if the surrogate foreign corporation is treated as a domestic corporation under section 7874(b).

**KPMG observation**

The JCT explanation of the administration’s FY 2013 proposal\(^4\) discusses in detail the stripping of earnings by entities, which inverted successfully prior to the effective date of section 7874, including a thorough analysis of a Treasury report prepared to evaluate the impact of earnings stripping. The JCT explanation points out that the administration’s proposal did not address earnings stripping transactions involving the payment of deductible amounts other than interest (e.g., rents, royalties, reinsurance premiums, and service fees) or the payment of deductible amounts by taxpayers other than corporations. The JCT explanation states that “[t]hese transactions also may erode the U.S. tax base, and thus some argue that a more comprehensive response to

\(^4\) Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal* ([JCS-2-2012](https://www.jct.gov)), June 2012.
earnings stripping is needed.” The JCT explanation does not offer any specific proposals, however, with respect to these other types of payments.

Modify the tax rules for dual-capacity taxpayers

The administration’s FY 2014 proposal also includes a provision that would cap a dual-capacity taxpayer’s foreign tax credit from a jurisdiction at the amount of tax the dual-capacity taxpayer would pay in that jurisdiction if it were not a dual-capacity taxpayer (i.e., subject to the generally applicable income tax laws). This provision would not override any treaty that explicitly allows a credit for taxes paid or accrued on certain oil or gas income. This aspect of the proposal would be effective for amounts that, if such amounts were an amount of tax paid or accrued, would be considered paid or accrued in tax years beginning after December 31, 2013.

The proposal also would convert the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income.

KPMG observation

Some observers note that this proposal could produce a harsh result—zero foreign tax credits—for dual-capacity taxpayers operating in foreign jurisdictions that do not generally impose an income tax.

The dual-capacity taxpayer rules apply primarily to oil and gas producers, but also may apply to other businesses, e.g., a corporation loaning money to a foreign government or a government contractor.

Tax gain from the sale of a partnership interest effectively connected income (ECI) on look-through basis

The administration’s FY 2014 proposal includes a provision that would characterize gain or loss from the sale or exchange of a partnership interest as income effectively connected with the conduct of a trade or business in the United States (ECI) to the extent attributable to the transferor partner’s distributive share of the partnership’s unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

The proposal would also provide a collection mechanism in the form of gross basis withholding. The transferee of a partnership interest would be required to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certified that the transferor was not a nonresident alien individual or foreign corporation. Alternatively, if a transferor provided a certificate from the IRS that established that the transferor’s federal income tax liability with respect to the transfer was less than 10% of the amount realized, the transferee would withhold such lesser
If the transferee failed to withhold the correct amount, the partnership would be liable for the amount of underwithholding, and would satisfy the withholding obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

KPMG observation

The proposal would codify the position set out in Rev. Rul. 91-32, which provides that gain or loss of a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent of the partner’s distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership’s trade or business within the United States (ECI property).

The withholding mechanisms set out to enforce collection of this tax appear very similar to the gross basis withholding imposed on the disposition of a U.S. real property interest under section 1445 (FIRPTA withholding). It is unclear to what extent liability would be imposed for failure to withhold in the absence of the required certifications but when the ultimate liability was less than the amount required to be withheld under the general rule.

Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment

The administration has also proposed a substantial limitation on the ability for corporations to utilize leveraged distributions as a means of avoiding dividend treatment on distributions from foreign corporations.

The administration’s FY 2014 proposal provides that, to the extent a foreign corporation (the “funding corporation”) funds a second, related foreign corporation (the “foreign distributing corporation”) with a principal purpose of avoiding dividend treatment on distributions to a U.S. shareholder, the U.S. shareholder’s basis in the stock of the distributing corporation would not be taken into account for the purpose of determining the treatment of the distribution under section 301. For this purpose, the funding corporation and the foreign distributing corporation are related if they are members of a controlled group within the meaning of section 1563(a), but replacing the reference to “at least 80%” with “more than 50%.” Funding transactions to which the proposal would apply include capital contributions, loans, or distributions to the foreign distributing corporation, whether the funding transaction occurs before or after the distribution.

KPMG observation

It is worth noting that the provision does not recharacterize the distribution as a dividend, but rather eliminates consideration of the U.S. shareholder’s basis in the distributing corporation for purposes of section 301. This has the effect of rendering any amount that would have been a return of basis as a capital gain instead. This does not
result in the equivalent treatment as a dividend. First, the earnings and profits of the funding corporation remain unchanged, and thus could ultimately lead to an additional U.S. income tax inclusion, in addition to the inclusion triggered by the leveraged distribution. Second, the leveraged distribution results in a U.S. source capital gain, which may be offset by capital losses but which would not serve to increase the foreign tax credit limitation available to the taxpayer.

**Extend section 338(h)(16) to certain asset acquisitions**

The administration’s FY 2014 proposal would extend the application of section 338(h)(16) to any covered asset acquisition, within the meaning of section 901(m).

**KPMG observation**

This provision extends the reach of section 338(h)(16), which requires the calculation of the source and character of items for foreign tax credit purposes to be made without taking into account the impact of a section 338 election, to all covered asset acquisitions, as defined in section 901(m). Among the affected transactions would be the acquisition of a hybrid entity that is treated as a disregarded entity for U.S. tax purposes but a corporate entity for foreign tax purposes, or an acquisition of a partnership for which a section 754 (basis adjustment) election is in place.

This provision would extend the general principle that, for purposes of calculating the foreign tax credit allowable in the United States, the source and character of income would be determined by treating acquisitions made by a taxpayer in a manner consistent with their treatment under foreign law. Thus, to the extent foreign law would treat an acquisition as a purchase of stock, for purposes of calculating the foreign tax credit limitation, items relating to that purchase would be sourced as though the purchase were a stock purchase. In the case of a U.S. seller, this would result in all items of income or expense originating from assets acquired in a transaction covered by section 901(m) being treated for foreign tax credit purposes as domestic source capital gains or losses, regardless of the source and character they would otherwise have.

**Remove foreign taxes from a section 902 corporation’s foreign tax pool when earnings are eliminated**

The administration’s FY 2014 proposal would reduce the amount of foreign taxes paid by a foreign corporation in the event a transaction results in the elimination of a foreign corporation’s earnings and profits other than a reduction of earnings and profits by reason of a dividend or deemed dividend, or by reason of a section 381 transaction. The amount of foreign taxes that would be reduced in this type of transaction would equal the amount of foreign taxes associated with the eliminated earnings and profits.
KPMG observation

To the extent that current law adjusts foreign tax pools only on account of dividends and subpart F inclusions, it can have the effect of separating foreign taxes from the income to which they relate. Thus, to some extent, this proposal could be viewed as a further (albeit very narrow) extension of the principles underlying section 909.

Provide for reciprocal reporting of information in connection with the implementation of FATCA

The administration’s FY14 proposal would provide the Secretary with authority to prescribe regulations that would require U.S. financial institutions to report information to the IRS with respect to accounts of non-resident alien individuals, entities that are not U.S. persons, and certain U.S. entities held in substantial part by non-U.S. owners, that is similar to the information that FATCA (the Foreign Account Tax Compliance Act) requires foreign financial institutions to report regarding U.S. accounts. The information required to be reported by U.S. financial institutions would include information regarding account balances and payments made with respect to accounts held by such persons and entities.

KPMG observation

As anticipated, the administration’s FY 2014 proposal addresses the United States’ commitment to enhancing the information reporting requirements of U.S. financial institutions in an effort to improve its ability to exchange information pursuant to a reciprocal Intergovernmental Agreement (IGA), an alternative to the new FATCA information reporting regime. Pursuant to the Model I IGA (with reciprocity), the United States agrees to exchange the information that it currently collects from U.S. financial institutions maintaining non-resident alien (NRA) accounts. In addition, because the IGA tasks foreign financial institutions with more onerous due diligence and reporting requirements (e.g., the requirement to identify certain U.S. owners of passive entities and to report detailed account information), the United States explicitly agrees to enhancing the information it would exchange by “pursuing the adoption of regulations and advocating and supporting relevant legislation to achieve” equivalent levels of information.

Significant to this, the U.S. financial community has voiced a concern that this commitment could result in a requirement that a U.S. financial institution look through entities that are considered beneficial owners under U.S. tax principles (e.g., corporations and complex trusts) in an effort to identify and report on underlying owners that are residents of countries that have entered into reciprocal IGAs. This concern was exacerbated by Treasury’s announcement that it intends to conclude over 50 IGAs by the end of this year.
While the proposal would require a U.S. financial institution to report additional information with respect to its NRA accounts (e.g., account balances), it appears to limit the “look-through” requirement to U.S. entities only. Thus, for example, it appears that a U.S. financial institution maintaining an account for a non-U.S. corporation would continue to report at the corporate level and the information exchanged with respect to that account, if any, would be with the country in which the corporation was organized. Conversely, when the account holder is a U.S. corporation, the proposal would require the U.S. financial institution to look through the entity for any non-U.S. persons holding “substantial” interests and reporting on that underlying owner level. Though such a change would be a vast modification to the current reporting rules, it could provide some relief to those members of the financial community that feared a more drastic recommendation.

FINANCIAL AND INSURANCE INDUSTRY INSTITUTIONS AND PRODUCTS

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

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

The administration’s FY 2014 proposal would eliminate sections 1256 and 1092 of the Code, generally requiring instead that gain or loss from a “derivative contract,” as defined in the proposal, be marked to market with the resulting gain or loss treated as ordinary gain or loss. The proposal would also curtail the application of several other Code sections related to the timing and character of gain or loss with respect to derivative contracts, but the source of income from the contract would continue to be determined under current law.

The proposal would define a derivative contract to include: (1) any contract the value of which is determined, directly or indirectly, in whole or in part, by the value of actively traded property; and (2) any contract with respect to a contract described in clause (1). An embedded derivative contract would also be subject to mark to market if the derivative itself would be. Thus, contingent debt or structured notes linked to actively traded property would be taxed as derivative contracts under the proposal.

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

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

The proposal would apply to derivative contracts entered into after December 31, 2013.

**KPMG observation**

The House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments⁵, released on January 24, 2013, contains a provision that requires mark-to-market treatment of “derivatives,” as defined in the draft that is similar to the mark to market of “derivative contracts” provision contained in the administration’s FY 2014 proposal. There are, however, some notable differences including the types of derivatives that are subject to mark-to-market treatment. One such difference is that the Ways and Means draft’s definition of “derivative” includes interests or instruments that themselves are not actively traded and that refer to property that is not actively traded. The draft, however, only imposes mark-to-market treatment on derivative contracts when the value of the derivative contract is determined, directly or indirectly, in whole or in part, by the value of actively traded property.

Although the administration’s FY 2014 proposal provides a framework for more uniform treatment of derivative contracts, taxpayers would still need to determine whether a particular financial instrument fits the definition of a derivative contract and thus be subject to mark-to-market treatment. Several details will need to be clarified, such as what constitutes actively traded property or an embedded derivative.

**Modify rules that apply to sales of life insurance contracts**

The administration’s FY 2014 proposal would require a person or entity who purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer’s and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

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⁵ Technical explanation of the Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments (January 24, 2012)
The proposal also would modify the transfer-for-value rule so that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

The provision would apply to sales or assignments of interests in life insurance policies and payments of death benefits in tax years beginning after December 31, 2013.

**KPMG observation**

This provision was designed to address life settlement transactions. The proposal imposes reporting burdens on both purchasers of life insurance contracts and on life insurance companies that pay death benefits. It has been observed that the requirement for the insurance company to “estimate” a policy purchaser’s basis in the contract being reported on is fraught with uncertainty and may lead to inaccurate reporting.

This provision was included in the administration’s 2012 and 2013 revenue proposals.

**Modify proration rules for life insurance company general and separate accounts**

The administration’s FY 2014 proposal would repeal the existing regime for prorating investment income between the "company's share" and the "policyholders' share." The general account dividends received deduction (DRD), tax-exempt interest, and increases in certain policy cash values of a life insurance company would instead be subject to a flat 15% proration rule similar to the current law non-life insurance company proration rule. The limitations on the DRD that apply to other corporate taxpayers would be expanded to apply explicitly to life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of the account. The proposal would thus put the company’s general account DRD on a similar footing to that of a non-life company, and would put its separate account DRD on a similar footing to that of any other taxpayer with a diminished risk of loss in stock that it owns, or with an obligation to make related payments with regard to dividends.

The provision would be effective for tax years beginning after December 31, 2013.

**KPMG observation**

The separate account DRD has been an issue between the life insurance industry and the IRS for many years. Previous proposals would have essentially eliminated the separate account DRD. The current proposal would do the same, plus would change proration for the general account DRD and eliminate the “company’s share” calculation.

This provision was included in the administration’s 2012 and 2013 revenue proposals.
Expand pro rata interest expense disallowance for corporate-owned life insurance (COLI)

The administration’s FY 2014 proposal would repeal the section 264(f)(4)(A)(ii) exception from the overall section 264(f) pro rata interest expense disallowance rule for life insurance, annuity, and endowment contracts covering employees, officers, or directors of a business that is the owner or beneficiary of the contracts. The proposal would leave intact the section 264(f)(4)(A)(i) exception for contracts covering 20% owners of the business that owns the contract.

The proposal would apply to contracts issued after December 31, 2013, in tax years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract would cause the contract to be treated as a new contract, except in the case of a master contract, for which the addition of covered lives would be treated as a new contract only with respect to the additional covered lives.

KPMG observation

This provision, which diminishes the attractiveness of purchasing corporate owned life insurance (COLI), was included in the administration’s 2011 through 2013 revenue proposals.

ENERGY

Eliminate fossil fuel preferences

The administration’s FY 2014 proposal would repeal several preferences currently available to the oil and gas sector:

- Repeal the section 43 enhanced oil recovery credit
- Repeal the section 45I credit for qualified crude oil and natural gas production from a marginal well
- Repeal the section 263(c) expensing of intangible drilling costs
- Repeal the section 193 deduction for tertiary injectants
- Repeal the section 469(c)(3) exception to passive loss limitation for working interests in oil and natural gas properties
- Repeal percentage depletion for oil and natural gas wells
- Repeal the section 199 domestic manufacturing deduction for oil and natural gas and coal and hard mineral activities
- Increase geological and geophysical amortization period for independent producers to seven years under section 167(h)
- Repeal expensing of mining exploration and development costs
- Repeal percentage depletion for hard mineral fossil fuels
- Repeal capital gains treatment for coal and lignite royalties
KPMG observation

One last observation perhaps worth noting is that the administration’s FY 2013 budget included an extension of nearly a dozen energy-related extenders in the revenue table. These expiring provisions relate principally to fuels and energy efficiency incentives. These items are not included for extension in the FY 2014 revenue tables. It is not yet clear whether this represents a policy decision by the administration to allow these provisions to expire or whether it is simply a matter of how the items are presented in the budget.

OTHER CHANGES

Repeal the excise tax credit for distilled spirits with flavor and wine additives

Section 5010 of the Code allows a credit against the $13.50 per proof-gallon excise tax on distilled spirits for flavor and wine additives, thereby reducing the effective excise rate paid on distilled spirits with such content. The credit is available on distilled spirits that are produced in the United States as well as on distilled spirits that are imported into the United States.

The administration’s FY 2014 proposal would repeal the section 5010 credit for distilled spirits, and tax all distilled spirit beverages at the $13.50 per proof-gallon rate, effective for all spirits produced in or imported into the United States after December 31, 2013.

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 2014 proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2013. 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.
KPMG observation

If use of the International Financial Reporting Standards (IFRS) becomes mandatory, companies would be forced to discontinue using the LIFO method for financial reporting purposes. As a consequence, companies would not be able to use the LIFO method for tax purposes because it would not be possible for them to comply with the conformity requirement.

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 2014 proposal would repeal the use of the LCM and subnormal goods methods for the first tax year beginning after December 31, 2013. 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.

Eliminate special 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.

Effective for property placed in service after December 31, 2013, the administration’s FY 2014 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 includes 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-passage activity (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 gain limitation for dividends received in reorganization exchanges

Section 356(a)(1) currently provides that if, as part of a reorganization, a shareholder receives stock and boot in exchange for its stock in the target corporation, then the shareholder recognizes gain, but not in excess of the boot (the so-called “boot within gain” limitation). Under section 356(a)(2), if the exchange has the effect of the distribution of a dividend, then all or part of the gain recognized by the shareholder is treated as a dividend to the extent of the shareholder’s ratable share of the corporation’s earnings and profits, with the remainder of the gain treated as gain from the exchange of property (generally capital gain).

The administration’s FY 2014 proposal would repeal the “boot within gain” limitation in the case of any reorganization if the exchange has the effect of the distribution of a dividend under section 356(a)(2) and would apply to tax years beginning after December 31, 2013.

KPMG observation

The administration’s FY 2011 through FY 2013 proposals contained similar provisions.

The JCT explanation of the administration’s FY 2011 proposal states that one issue the administration needed to clarify is whether the accumulated earnings and profits of both the transferor and transferee corporation must be taken into account in determining the deemed dividend under section 356(a)(2) or whether the earnings and profits of only the transferor corporation must be taken into account for such purpose. The JCT explanation further notes that the proposal may have unintended consequences that may be used affirmatively by taxpayers for tax planning purposes.

Expand the definition of built-in loss for purposes of partnership loss transfers

Under current law, if there is a transfer of a partnership interest, the partnership is required to adjust the basis of its assets with respect to the transferee partner if the partnership at that time has a substantial built-in loss in its assets, i.e., if the partnership’s adjusted basis in its assets exceeds the fair market value of its assets by more than $250,000. This rule is intended to prevent the duplication of losses.

The administration’s FY 2014 proposal would extend the mandatory basis adjustment rules with respect to transfers of partnership interests to require an adjustment with respect to the transferee partner if such partner would be allocated a net loss in excess

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6 Joint Committee on Taxation, Description of Revenue Provisions Contained in the President’s Fiscal Year 2011 Budget Proposal (JCS-2-2010), August 16, 2010.
of $250,000 if the partnership were to sell its assets for cash for fair market value in a fully taxable transaction immediately after the transfer. This adjustment would be required even if the partnership as a whole did not have a substantial built-in loss.

The JCT\(^7\) provided an example of when the provision could apply in its description of a substantially similar budget proposal for FY 2013. In that example, a partnership has two assets, one of which (Asset X) has a built-in gain of $1 million and the other of which (Asset Y) has a built-in loss of $900,000. The partnership has three taxable partners – A, B, and C. The partnership agreement specially allocates to A any gain on sale or exchange of Asset A; the partners share equally in other partnership items. Although the partnership does not have an overall built-in loss, each of B and C has a net built-in loss of $300,000 allocable to his partnership interest (one-third of the loss attributable to Asset Y). If C were to sell his partnership interest to another person (D), the proposal would require a mandatory basis adjustment with respect to D. The JCT explanation notes that, if an adjustment were not made, the purpose of the current mandatory basis adjustment rules for built-in losses arguably would not be carried out.

The provision would apply to sales or exchanges after the date of enactment.

**Extend partnership basis limitation rules to nondeductible expenditures**

A partner’s distributive share of partnership losses for a tax year is allowed only to the extent of the partner’s adjusted basis in its partnership interest at the end of the partnership tax year. Losses that are disallowed under this rule generally are carried forward and are allowed as deductions in future tax years to the extent the partner has sufficient basis at such time. The IRS issued a private letter ruling in 1984 concluding that this loss limitation rule does not apply to limit a partner’s deduction for its share of the partnership’s charitable contributions.

The administration’s FY 2014 proposal would modify the statutory loss limitation rule to provide that a partner’s distributive share of expenditures not deductible by the partnership (or chargeable to capital account) is allowed only to the extent of the partner’s adjusted basis in the partnership interest at the end of the year.

A JCT explanation of a substantially similar budget proposal for FY 2013\(^8\) indicates that the current loss limitation rule is intended to limit a taxpayer’s deductions to its investment in the partnership (taking into account its share of partnership debt). The JCT explanation suggests that the administration’s proposal is intended to address the following concern:

> Because of a technical flaw in the statute, which was written in 1954, it appears that the limitation does not apply, for example, to charitable contributions and

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\(^7\) Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal (JCS-2-2012)*, June 2012.

\(^8\) Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President’s Fiscal Year 2013 Budget Proposal (JCS-2-2012)*, June 2012.
foreign taxes of the partnership, because those items are not deductible in computing partnership income. Because a partner’s basis cannot be decreased below zero, a partner with no basis is allowed a deduction (or credit) for these items without having to make the corresponding reduction in the basis of his partnership interest that would otherwise be required.

The provision would apply to partnership tax years beginning on or after the date of enactment.

Limit the importation of losses under section 267(d)

Generally, a loss cannot be recognized if it is from a sale or exchange of property between certain related persons, including an individual and a more-than-50% owned corporation or partnership, or two corporations or partnerships in which the individual has a more-than-50% ownership. However, section 267(d) allows the transferee to apply that loss against any gain on a later disposition of the transferred asset.

The administration’s FY 2014 proposal would amend section 267(d) so that the transferee could not apply such a loss to the later transaction to the extent that gain or loss with respect to such property is not subject to U.S. federal income tax in the hands of the transferor immediately before the transfer, but any gain or loss with respect to such property is subject to U.S. federal income tax in the hands of the transferee immediately after the transfer. This would appear to apply, among other situations, when the transferor is a foreign person not subject to U.S. federal income tax and the related transferee is a person subject to U.S. federal income tax.

The provision would apply to transfers made after the date of enactment.

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 2014 proposal would prohibit any deduction for punitive damages paid or incurred by the taxpayer, whether upon a judgment or 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, 2014.
Eliminate section 404(k) employee stock ownership plan (ESOP) dividend deduction for large C corporations

The administration’s FY 2014 proposal would repeal the deduction for dividends paid with respect to stock held by an ESOP that is sponsored by a C corporation (subject to an exception for C corporations with annual receipts of $5 million or less). The current law rules allowing for immediate payment or use of an applicable dividend would remain intact, without a deduction, and would be moved to section 4975(f)(7), which currently provides corresponding rules for distributions (as described in section 1368(a)) with respect to S corporation stock held in an ESOP maintained by a S corporation that is used to repay the loan(s) with which the stock, with respect to which the distribution is paid, was originally purchased. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

The proposal would apply to dividends and distributions that are paid after the date of enactment.
BUDGET PROPOSALS

JOBS AND GROWTH

Provide 10% tax credit for new jobs and wage increases

The administration’s FY 2014 proposal would provide a tax credit for increases in wage expense, whether driven by new hires, increased wages, or both. The credit would be equal to 10% of the increase in the employer’s eligible wages paid during the credit period over the employer’s eligible wages paid during the base period. Base period wages are calculated using wages paid in 2012. The credit period is the 12-month period following the date of enactment. Eligible wages are defined as the employer's Old Age Survivors and Disability Insurance (OASDI) wages. The maximum amount of the increase in eligible wages would be $5 million per employer, for a maximum credit of $500,000. For employers with no OASDI wages in the base period, eligible wages would be 80% of their OASDI wages paid in the credit period. To focus the benefit on small businesses, the credit would be limited to employers with less than $20 million in OASDI wages in 2012.

The administration’s FY 2014 proposal provides that the credit generally would be considered a general business credit and thus would not be refundable and would not offset AMT liability. A similar credit would be provided for qualified tax-exempt employers and public institutions of higher learning (but not other government employers). The credit would only apply with respect to the wages of employees performing services in a trade or business of a qualified employer or, in the case of a qualified employer exempt from tax under section 501(a), in furtherance of the activities related to the purpose or function constituting the basis of the employer’s exemption under section 501. Self-employment income would not be considered eligible wages.

The provision would be effective for qualified wages paid during the 12-month period beginning on the date of enactment.

Provide additional section 48C investment tax credits for qualified advanced energy manufacturing projects

The administration’s FY 2014 proposal would extend the qualified advanced energy property credit.

The qualified advanced energy property (QAEP) credit under section 48C is a 30% investment tax credit that is available for the construction, re-equipping, or expansion of a manufacturing facility that constructs QAEP. Included in the definition of QAEP is property such as solar, wind, and other renewable energy component property; electric grids, carbon dioxide capture and sequestration property; plug-in electric vehicles and component parts, etc. QAEP credits were first enacted as part of the American Recovery and Reinvestment Act of 2009, and $2.3 billion in QAEP credits were
originally authorized. All of the credits were allocated by Treasury in the initial allocation round in January 2010.

The administration’s FY 2014 proposal would authorize an additional $2.5 billion in credits, increasing the amount of credits that can be certified by Treasury to $4.8 billion. Under the administration’s FY 2014 proposal, taxpayers would be allowed to apply for a credit with respect to all of or only a part of the qualified investment in the project. If a taxpayer applies for a credit with respect to only a portion of its qualified investment, the project would be given priority in the allocation process.

INVESTMENT IN INFRASTRUCTURE

Provide America Fast Forward bonds and expand eligible uses

The American Recovery and Reinvestment Act of 2009 enacted the Build America Bonds (BABs). BABs were taxable bonds issued by state and local governments where the Treasury Department pays (through refundable tax credits) 35% of the coupon interest on the BABs directly to the state and local governmental issuers. BABs could be issued only for original financing for public capital projects for which issuers could otherwise use tax-exempt governmental bonds, and they could be issued without volume limitation. During 2009 and 2010, BABs gained one-third of the total dollar supply of state and local new, long-term governmental debt.

The administration’s FY 2014 proposal would create a new, permanent America Fast Forward (AFF) bond program. Like BABs, AFF bonds would be taxable bonds issued by state and local governments where the Treasury Department pays (through refundable tax credits) 28% of the coupon interest on the AFF bonds directly to state and local governmental issuers. This 28% federal subsidy level is intended to be approximately revenue neutral relative to the estimated future federal tax expenditures for tax-exempt bonds.

Eligible uses for AFF bonds would include:

- Original financing for governmental capital projects
- Current refundings of prior public capital project financings for interest cost savings when the prior bonds are repaid promptly within 90 days of issuance of the current refunding bonds
- Short-term governmental working capital financings for governmental operating expenses
- Financing for section 501(c)(3) nonprofit entities

Eligible uses would also include financing for the types of projects and programs that can be financed with qualified private activity bonds, subject to the applicable state bond volume caps for the qualified private activity bond category.

The proposal would be effective for bonds issued on or after January 1, 2014.
**KPMG observation**

The proposed AFF bond program is similar to the White House’s FY 2013 proposal for making permanent the BAB program at a federal subsidy level of 30% of the coupon interest on the bonds through 2013, and 28% thereafter.

In addition to containing all the eligible uses that the BAB program contained, the proposed AFF bond program would contain another eligible use—financing for the types of projects and programs that can be financed with qualified private activity bonds, subject to the applicable state bond volume caps for the qualified private activity bond category.

**Increase federal subsidy rate for America Fast Forward bonds for school construction**

State and local governments issue tax-exempt bonds to finance a broad range of projects, including school construction. In addition to tax-exempt bonds, Build America Bonds (BABs) are another way to finance educational facilities. In 2009 and 2010, approximately $50 billion of BABs were issued to finance education.

The proposal provides a temporary 50% federal subsidy rate for America Fast Forward (AFF) bonds for school construction. Eligible uses would be: (1) original financings for governmental capital projects for public schools and state universities; and (2) new money financings for section 501(c)(3) nonprofit educational entities. For AFF bonds for school construction issued in 2014 and 2015, the Treasury Department would pay (through refundable tax credits) 50% of the coupon interest on the AFF bonds directly to state and local governmental issuers. The 50% federal subsidy rate would not apply to current refundings of prior governmental capital financings for public schools and state universities or current refundings of prior financings for section 501(c)(3) educational entities.

The proposal would be effective for bonds issued in 2014 and 2015.

**Allow current refundings of state and local governmental bonds**

With respect to tax-exempt bonds issued by state and local governments, a “current refunding” or “current refunding issue” refers to bonds issued to refinance another outstanding bond issue in circumstances when the outstanding bonds are redeemed or retired within 90 days after issuance of the current refunding bonds. Typically, the primary reason that state and local governments engage in current refunding transactions is to reduce interest costs.

Currently, the extent to which statutory provisions address current refunding varies among different state and local bond provisions. In order to promote greater uniformity and increased certainty, the administration’s FY 2014 proposal would set forth a general Code provision to authorize current refunding of state or local bonds upon satisfaction of certain requirements related to the size and maturity of the bonds. The provision would
generally apply to state and local bond programs that do not otherwise allow current refunding or expressly address the treatment of current refunding. It would not affect refunding of bonds when current refundings are already allowed. The provision would be effective as of the date of enactment.

Exempt foreign pension funds from the application of FIRPTA

The administration’s FY 2014 proposal would exempt foreign pension funds from U.S. taxation under the Foreign Interest in Real Property Tax Act (FIRPTA) on gain from the disposition of U.S. real property interests. For this purpose, a foreign pension fund would generally mean a trust, corporation, or other organization or arrangement that: (1) is created or organized outside of the United States; (2) is generally exempt from income tax in the jurisdiction in which it is created or organized; and (3) substantially all of the activity of which is to administer or provide pension or retirement benefits. The Secretary would be granted authority to issue regulations necessary to carry out the purposes of the proposal, including whether for this purpose an entity or arrangement is a foreign pension fund or a benefit is a pension or retirement benefit.

KPMG observation

Unlike the other international proposals, which are intended to raise revenue, the FIRPTA proposal is an expenditure intended to encourage foreign investment in U.S. infrastructure by exempting foreign pension funds from U.S. tax on gain from the disposition of U.S. real property investments. The FIRPTA proposal is similar to a suggested legislative change contained in an article written by KPMG in 2011.⁹

Other bond proposals

The administration’s FY 2014 budget also contains several bond proposals intended to provide incentives for investment in infrastructure, including private investment. These are:

- 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
- Eliminate the volume cap for private activity bonds for water infrastructure
- Increase to 35% the 25% limit on land acquisition restriction on qualified private activity bonds
- Allow more flexible research arrangements for purpose of the private business use limitations
- Repeal the government ownership requirement for certain types of exempt facility bonds

Other tax-exempt bond proposals

Among the administration’s FY 2014 proposals specifically affecting tax-exempt organizations and the non-profit sector are measures that would simplify tax-exempt bonds by simplifying arbitrage investment restrictions, simplifying single-family housing mortgage bond targeting requirements, and streamlining private business use limits on government bonds.

FAMILIES AND INDIVIDUALS

Provide for automatic enrollment in individual retirement accounts (IRAs) and double the tax credit for small employer plan start-up costs

The administration’s FY 2014 proposal would require employers in business for at least two years that have more than 10 employees to offer an automatic IRA option to employees. Contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsors a qualified plan, it would not be required to provide an automatic IRA. However, if the employer excluded from eligibility a portion of the workforce or class of employees, the employer would be required to offer the automatic IRA option to those excluded employees.

Small employers (those with no more than 100 employees) that offer automatic IRA enrollment could claim a temporary non-refundable credit for expenses associated with the arrangement of up to $500 for the first year and $250 for the second year. Such employers would be entitled to an additional non-refundable credit of $25 per enrolled employee, up to a maximum of $250 for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (for example, because they have 10 or fewer employees).

In addition, the “start-up costs” tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE plan would be doubled from the current maximum of $500 per year for three years to a maximum of $1,000 per year for three years and extended to four years (rather than three) for any employer that adopts a new qualified plan during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This credit would not apply to the automatic IRAs.

The provision would be effective after December 31, 2014.

Expand the child and dependent care tax credit

Under current law, a nonrefundable tax credit is allowed to certain working taxpayers for up to 35% of their child and dependent care expenses, limited to $3,000 of eligible expenses for one child or dependent, and $6,000 for two or more. The 35% rate decreases by one percentage point for every $2,000 (or part thereof) of adjusted gross income (AGI) over $15,000 until the percentage reaches 20% for AGI above $43,000.
The administration’s FY 2014 proposal would raise the threshold for phasing out the 35% credit rate from $15,000 to $75,000, with the 20% credit rate applying when AGI exceeds $103,000.

This change would be effective for tax years beginning after December 31, 2013.

**Extend exclusion from income for cancellation of home mortgage debt**

Gross income generally includes income realized from the discharge of indebtedness. Under current law, an exception to this general rule exists for qualified principal residence interest (QPRI), which is acquisition indebtedness with respect to a taxpayer’s principal residence, limited to $2 million ($1 million if married filing separately). Pursuant to this exception, taxpayers are allowed to exclude income from the discharge of QPRI. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, qualifies for QPRI relief, which applies to debt forgiven in calendar years 2007 through 2013.

The administration’s FY 2014 proposal would extend the exclusion from income for QPRI to amounts that are discharged before January 1, 2016, and to amounts that are discharged pursuant to an agreement entered into before that date.

**Provide exclusion from income for student loan forgiveness for students in certain income-based or income-contingent repayment programs**

The administration’s FY 2014 proposal would exclude from gross income amounts forgiven at the end of the maximum 25-year repayment period for student loans made under the Federal Direct Loan Program or the Federal Family Education Loan Program when the borrower has been making repayments under the income-contingent or income-based repayment options. Such forgiven amounts would otherwise result in taxable income to the borrowers.

The provision would be effective for loans forgiven after December 31, 2013.

**Provide exclusion from income for student loan forgiveness and certain scholarship amounts for participants in the Indian Health Service (IHS) health professions programs**

The administration’s FY 2014 proposal would allow scholarship funds for qualified tuition and related expenses received under the Indian Health Service (IHS) health professions scholarship program to be excluded from income, even though participants in this program incur a work requirement. The proposal would also allow participants in the IHS loan repayment program to exclude from income certain student loan amounts forgiven by the IHS loan repayment program.

This provision would be effective for tax years beginning after December 31, 2013.
UPPER-INCOME

Reduce the value of certain tax expenditures

The administration’s FY 2014 proposal would limit the tax value of certain specified deductions and exclusions from AGI, and all itemized deductions. This limitation would reduce to 28% the value of these deductions and exclusions that would otherwise reduce taxable income in the 33%, 35%, or 39.6% tax brackets. A similar limitation would apply under the alternative minimum tax.

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

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

The General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals (Green Book) does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 36% tax bracket with a $10,000 itemized deduction or exclusion would be able to reduce their tax liability by only $2,800 on account of the deduction or exclusion, rather than $3,600—a tax increase of $8 per $100 of itemized deductions compared to current law.

This provision would be effective for tax years beginning after December 31, 2013.

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 that rise as high as 39.6%. The wage base for much of the payroll tax is capped at $113,700 in 2013, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below that amount. Many high-income taxpayers derive large benefits from the preferentially low tax rates on dividends and capital gains. High-income investors, who have large amounts of dividends and capital gains, can have tax burdens that are much lower than those paid by equally well-off high-income workers. The maximum 23.8% tax rate on dividends and capital gains means that a high-income taxpayer whose income is largely derived from capital gains
or dividend income may have a lower average tax rate than a lower-income taxpayer whose income is largely or exclusively derived from wages.

The administration’s FY 2014 proposal would impose a new minimum tax, called the Fair Share Tax (FST) phasing in for taxpayers having $1 million of adjusted gross income (AGI). The tentative FST equals 30% of AGI less a credit for charitable contributions. The charitable credit equals 28% of itemized charitable contributions allowed after the limitation on itemized deductions (so-called Pease limitation). Final FST is 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 is fully phased in at $2 million of AGI ($1 million if married filing separately). AGI thresholds are indexed for inflation beginning after 2014.

The proposal would be effective for tax years beginning after December 31, 2013.

**ESTATE AND GIFT TAX**

**Restore the estate, gift, and generation-skipping transfer (GST) tax parameters in effect in 2009**

The *Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010* enacted a top estate tax rate of 35% and unified the exemption for estate, gift, and GST with a total lifetime exclusion of $5 million starting in 2011. The exemption amount is indexed for inflation (it is $5.25 million in 2013). It also enacted the portability of the exemption between spouses for both gift and estate tax purposes. The *American Taxpayer Relief Act of 2013* permanently raised the top tax rate for estate, gift, and GST taxes to 40%. It also made permanent all the substantive estate, gift and GST tax provisions in effect during 2012.

Beginning in 2018, the administration’s FY 2014 proposal would make permanent the estate, GST, and gift tax parameters as they applied during 2009. The top tax rate would be 45% and the exclusion amount would be $3.5 million for estate and GST taxes, and $1 million for gift taxes. There would be no indexing for inflation. The proposal would confirm that no estate or gift tax would be incurred by reason of decreases in the applicable exclusion amount on a gift previously excluded at the time of transfer. The portability of unused estate and gift tax exclusion between spouses would be allowed.

The provision would be effective for the estates of decedents dying, and for transfers made, after December 31, 2017.

**Require consistency in value for transfer and income tax purposes**

Code section 1014 provides that the basis of property for income tax purposes acquired from a decedent generally is the fair market value of the property on decedent’s date of death or the estate tax alternative valuation date. Similarly, property included in the decedent’s gross estate for estate tax purposes generally must be valued at its fair market value on either of those dates. Though the same valuation standard applies to
both tax regimes, current law does not require that they be equal. The estate tax value provides only a rebuttable presumption of the property’s basis in the hands of the recipient.

Section 1015 provides that the donee’s basis in property received by gift during the life of the donor generally is the donor’s adjusted basis in the property. However, if such basis exceeds the fair market value of the property, for purposes of determining a loss, the donee’s basis is limited to fair market value at the time of the gift. No provision governs how the donor’s basis information is to be communicated to the donee.

Section 1022, applicable to the estates of decedents dying during 2010 if a timely election to that effect is made, provides that the basis of property acquired from such a decedent is the lesser of the decedent’s adjusted basis in that property or the fair market value of the property on the decedent’s date of death as increased by any additional basis allocated by the executor.

The administration’s FY 2014 proposal would impose both a consistency and a reporting requirement:

- The basis of property received by reason of death under section 1014 would equal the value of that property for estate tax purposes
- The basis of property received by gift during the life of the donor under section 1015 would equal the donor’s basis
- The basis of property acquired from a decedent to whose estate section 1022 is applicable would be the basis of that property, including any additional basis allocated by the executor, as reported on the Form 8939 filed by the executor
- A reporting requirement would be imposed on the executor of the decedent’s estate and on the donor of a lifetime gift to provide the necessary valuation and basis information to both the recipient and the IRS

A grant of regulatory authority would be included to provide details about the implementation and administration of these requirements, including rules for situations in which no estate tax return is required to be filed or gifts are excluded from gift tax under section 2503, for situations in which the surviving joint tenant or other recipient may have better information than the executor, and for the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return.

The provision would be effective for transfers on or after the date of enactment.

**Require a minimum term for grantor retained annuity trusts (GRATs)**

Code section 2702 provides that, if an interest in a trust is transferred to a family member, the value of any interest retained by the grantor is valued at zero ($0) for purposes of determining the gift tax value of the gift to the family member, unless the
retained interest is a qualified interest such as the fixed annuity interest retained by the grantor of a GRAT.

Thus, the value of the gift made upon creation of a qualified GRAT is determined by reducing the value of the property contributed to the trust by the value of the retained annuity. The value of the retained annuity is determined using a relatively modest rate of return prescribed by Treasury (the “section 7520 rate”) as the measure of the predicted growth in the trust assets.

GRATs typically are funded with assets that are expected to appreciate at a rate greater than the section 7520 rate, and the grantor typically retains an annuity for a term of years less than the grantor expects to survive. At the end of the term, the remaining assets generally are transferred to the children of the grantor with no payment of additional gift or estate tax. But if the grantor dies during the term, the assets are included in the grantor’s estate for estate tax purposes, and the GRAT’s benefit (the tax-free transfer of appreciation on the assets in excess of the annuity payments) is not realized.

Taxpayers have become adept at maximizing the benefit of the GRAT by minimizing the term (and reducing the risk that the grantor will die during the term) and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero.

The administration’s FY 2014 proposal would require, in effect, some downside risk in the use of this technique by imposing the requirement that a GRAT have a minimum term of 10 years and a maximum term of the life expectancy of the annuitant plus 10 years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. This would increase the risk that the grantor fails to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit.

The provision would apply to trusts created after the date of enactment.

Limit duration of generation-skipping transfer (GST) tax exemption

GST tax is imposed on gifts and bequests to transferees who are two or more generations younger than the transferor (e.g., the transferor’s grandchildren). Each person has a GST exemption ($5.25 million for 2013) that can be allocated to transfers made to such “skip persons,” whether outright or in trust. The allocation of GST exemption to a transfer excludes from the GST tax not only the amount of the assets equal to the exemption allocated, but also all appreciation and income on that amount. Many states have repealed limitations on the duration of trusts and now allow them to continue in perpetuity, resulting in an expansion of the transfer tax shield provided by the GST exemption.
The administration’s FY 2014 proposal would provide that, on the 90th anniversary of the creation of a trust, the GST exemption allocated to the trust would terminate. Specifically, this would be achieved by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from a different grantor are deemed to be held in a separate trust under section 2654(b), each such separate trust would be subject to the same 90-year rule, measured from the date of the first contribution by the grantor of that separate trust.

The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust, with one exception, as follows.

If, prior to the 90th anniversary of the trust, trust property is distributed to a trust for a beneficiary of the initial trust, and the distributee trust is as described in section 2642(c)(2), the inclusion ratio of the distributee trust would not be changed to one (with regard to the distribution from the initial trust) by reason of this rule. This exception is intended to permit an incapacitated beneficiary’s distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary as long as that trust is to be used for the sole benefit of that beneficiary and any trust balance remaining on the beneficiary’s death will be included in the beneficiary’s gross estate for federal estate tax purposes.

The other rules of section 2653 also would continue to apply, and would be relevant in determining when a taxable distribution or taxable termination occurs after the 90th anniversary of the trust. An express grant of regulatory authority would be included to facilitate the implementation and administration of this provision.

The provision would apply to trusts created after enactment (and to the portion of a pre-existing trust attributable to additions made after enactment).

**Coordinate certain income and transfer tax rules applicable to grantor trusts**

For income tax purposes, a grantor trust is taxed as if the grantor or another person owns the trust assets directly. For transfer tax purposes, however, the trust and the deemed owner are separate persons, and under certain circumstances, the trust is not included in the deemed owner’s gross estate for estate tax purposes at the death of the deemed owner. The lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences.

The administration’s FY 2014 proposal applies to any a person who is the deemed owner of all or a portion of a trust and who engages in a sale, exchange, or comparable transaction with the trust that is disregarded for income tax purposes due to the
person’s treatment as the deemed owner. The portion of the trust attributable to the property received by the trust in that transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction, would be subject to estate tax as part of the gross estate of the deemed owner, subject to gift tax if at any point during the deemed donor’s life that treatment is terminated, and would be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner’s obligation to the distributee) during the life of the deemed owner. The proposal reduces the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not change the treatment of any trust that is already includable in the grantor’s gross estate under existing provisions of the Code, including without limitation the following: grantor retained income trusts (GRITs); grantor retained annuity trusts (GRATs); personal residence trusts (PRTs); and qualified personal residence trusts (QPRTs). It would also not apply to any trusts having the exclusive purpose of paying deferred compensation under a nonqualified deferred compensation plan (if the assets of the trust may be used to satisfy claims of general creditors of the grantor) or trusts considered grantor because the assets can be used to pay for premiums on insurance held on the grantor’s life under section 677(a)(3).

The administration’s FY 2014 proposal would be effective with regard to trusts that engage in a described transaction on or after the date of enactment. Regulatory authority would be granted, including the ability to create exceptions to this provision.

**Extend the lien on estate tax deferrals provided under section 6166**

Section 6166 allows the deferral of estate tax on certain closely held business interests for up to 14 years from the (unextended) due date of the estate tax payment. This provision was enacted to reduce the possibility that the payment of the estate tax liability could force the sale or failure of the business. Section 6324(a)(1) imposes a lien on estate assets generally for the 10-year period immediately following the decedent’s death to secure the full payment of the estate tax. Thus, the estate tax lien under section 6324(a)(1) expires approximately five years before the due date of the final payment of the deferred estate tax under section 6166.

The administration’s FY 2014 proposal would extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period.

The provision would be effective for the estates of all decedents dying on or after the enactment date, as well as for all estates of decedents dying before the date of enactment as to which the section 6324(a)(1) lien has not expired on the effective date.
Clarify GST tax treatment of health and education exclusion trusts (HEETs)

Section 2503(e) exempts from gift tax all payments made directly to a provider of another’s medical care or to a school for another's tuition. Section 2611(b)(1) excludes from GST tax “any transfers which, if made during the donor’s life, would not be treated as a taxable gift by reason of section 2503(e).” Some taxpayers have created health and education exclusion trusts (HEETs) which provide for medical and tuition payments to be made for multiple generations, essentially exempting the trust assets from any future gift, estate or GST tax after the initial funding of the trust.

The administration's FY 2014 proposal would clarify that section 2611(b)(1) only applies to payments by a donor directly to the provider of the medical care or the school in payment of tuition and not to trust distributions, even if made for those same purposes.

The provision would be effective for all trusts created after the introduction of the bill proposing the change and to transfers after that date made to pre-existing trusts.

FINANCIAL INDUSTRY INSTITUTIONS AND PRODUCTS

Impose a financial crisis responsibility fee

The administration’s FY 2014 proposal would institute a financial crisis responsibility fee (Fee) to recover taxpayer dollars that were used to support various financial institutions under the Troubled Asset Relief Program (TARP). The Emergency Economic Stability Act provides the authority for TARP, which in turn requires that the “President propose an assessment on the financial sector to pay back the costs of these extraordinary actions”—this proposed Fee is that assessment. The Fee would go into effect on January 1, 2015.

The Fee would apply only to firms with more than $50 billion in consolidated assets that are bank or thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions (and U.S. companies owning or controlling these types of entities as of and after January 14, 2010) (collectively, covered institutions). For U.S. firms, the Fee would be assessed on all covered liabilities globally; U.S. subsidiaries of foreign firms would be consolidated for purposes of the $50 billion threshold. If the consolidated assets of a firm subject to the Fee fall below the $50 billion threshold for any period, the firm would not be subject to the Fee during that time.

The Fee would be assessed at a rate of 0.17% of covered liabilities, which is defined as the consolidated risk-weighted assets of the firm minus capital, insured deposits, and certain loans to small businesses. Also, with regard to insurance companies, certain insurance policy reserves and other policyholder obligations could be deducted in computing covered liabilities. Generally covered liabilities would be determined using information filed with state and federal regulatory bodies. Adjustments to the calculation of the Fee base (i.e., the covered liabilities) could be made to prevent avoidance. In
addition, a 50% discount would apply to more stable sources of funding, including long-
term liabilities.

The IRS would collect the Fee from entities subject to the Fee on the same schedule as
estimated income tax payments. The Fee would be deductible in computing corporate
income tax.

**KPMG observation**

When initially proposed in the administration’s FY 2011 budget proposal, the Fee was to
be imposed at a rate of 15 basis points and was expected to recover approximately $90
billion over a 10-year period. As the cost of TARP decreased, the Fee was reduced to
7.5 basis points in the administration’s FY 2012 budget proposal. Like the FY 2013
budget proposal, the FY 2014 budget proposal would impose the Fee at a rate of 17
basis points, subject to a 50% discount for more stable sources of funding, resulting in
approximately $59.3 billion of expected revenue over a 10-year period. President
Obama has indicated that, in addition to recouping the cost of TARP, the Fee could be
used to fund a broader housing reform plan.

The Fee would be deductible for U.S. federal income tax purposes, but because the
Fee is not described as a tax, it is not clear whether states would allow a tax deduction
for the Fee.

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

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

The administration’s FY 2014 proposal would require holders of debt instruments with
market discount to include market discount currently in taxable ordinary income as it
accrues. The proposal would require accrual of market discount on a constant yield
basis. The proposal would also limit the amount of market discount that must accrued to
the greater of (1) the bond’s yield to maturity plus 5%, or (2) the applicable federal rate
for such bond plus 10%.

The proposal would apply to debt securities acquired after December 31, 2013.
The proposal is based upon the premise that market discount that arises as a result of changes in interest rates or decreases in an issuer’s creditworthiness subsequent to issuance is economically similar to OID, and like OID is to be accrued into income currently.

The proposal notes that current inclusion of market discount has historically been complicated by the fact that the amount of market discount on a debt instrument can vary from holder to holder since it is based upon each holder’s acquisition price. The new information reporting rules would require brokers to include, on annual information returns, market discount accruals together with basis and other information for debt instruments, simplifying compliance by taxpayers as well as the administrability of the proposal. The information reporting rules for debt instruments would be effective January 1, 2014.

A similar proposal was included in the House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments, released on January 24, 2013.

Require that the cost basis of portfolio stock must be determined using an average basis method

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

For portfolio stock with respect to which the taxpayer has a long-term holding period, the administration’s FY 2014 proposal would require taxpayers to determine the basis of stock sold using an average basis method. The average basis method would be applied to all identical shares of portfolio stock with a long-term holding period held by the taxpayer, including stock held through a different broker or in a separate account, but would not apply to shares held in a nontaxable account, such as an individual retirement account. The statute would provide authority to the Secretary to draft regulations applying the average basis method to stock other than portfolio stock. Special rules could also be required to coordinate the average basis method with the rules applicable to stock in passive foreign investment company.

The proposal would apply to portfolio stock acquired on or after January 1, 2014.

A related proposal was included in the House Ways and Means Committee Discussion Draft Provisions to Reform the Taxation of Financial Instruments, released on January
The administration’s proposal is different from the Ways and Means Committee discussion draft in a number of ways, however. First, the administration's proposal would only apply to stock with respect to which a taxpayer has a long-term holding period, and only to stock acquired on or after January 1, 2014. The administration’s proposal is also limited to “portfolio stock.” The proposal does not define “portfolio stock.” This term is defined in section 246A, but it is not clear that the administration's proposal is relying upon this definition. The Ways and Means discussion draft would apply to all stock sold on or after January 1, 2014. Second, the administration's proposal would require taxpayers to apply average basis to all identical stock, whether held in the same account or multiple accounts with different brokers, while the Ways and Means proposal would apply the average basis method on an account-by-account basis. Because of the broker cost-basis reporting rules for stock apply on an account-by account-basis, the administration’s proposal would require taxpayers holding identical stock in multiple accounts to compute their average basis across accounts rather than relying upon annual statements provided by their brokers.

INFLATION ADJUSTMENTS

Replace the consumer price index (CPI) with the chained CPI for purposes of indexing tax provisions for inflation

The administration’s FY 2014 proposal would replace the consumer price index (CPI) currently used for certain inflation adjustments with “chained CPI”—generally a lower measure of inflation. Cost-of-living adjustments to social security, adjustments to tax brackets, and other tax provisions would be affected by the change.

Replacing CPI with “chained CPI” would increase revenues by $100 billion and reduce benefits such as social security by $130 billion.

“Chained CPI” is calculated using a formula that reflects the effect of substitution that consumers make in response to changes in relative prices. For example, if the price of pork increases while the price of beef decreases, consumers might shift away from pork to beef. In this example, “chained CPI” would increase, but not as much as CPI that is based on fixed purchase patterns.

OTHER REVENUE CHANGES

Increase Oil Spill Liability Trust Fund financing rate by one cent; apply the tax to other sources of crudes

For periods beginning after 2013, the administration’s FY 2014 proposal would increase by $0.01 per barrel the taxes imposed on crude oil and imported petroleum products under the Oil Spill Liability Trust Fund financing rate, to $0.09 per barrel beginning on January 1, 2014, and to $0.10 per barrel after December 31, 2017.

Currently, an excise tax is imposed on: (1) crude oil received at a U.S. refinery; (2) imported petroleum products entered into the United States for consumption, use, or
warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil. The administration’s proposal would extend the tax to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock.

The tax would be dedicated to the Oil Spill Liability Trust Fund.

**Reinstate superfund excise taxes**

For periods after December 31, 2013, and before January 1, 2024, the administration’s FY 2014 proposal would reinstate the following superfund excise taxes that were imposed before 1996:

- An excise tax on domestic crude oil and on imported petroleum products at a rate of $0.097 per barrel. The tax would also be extended to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock.
- An excise tax on listed hazardous chemicals at a rate that varied from $0.22 to $4.87 per ton.
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

The tax would be dedicated to the Hazardous Substance Superfund.

**Reinstate superfund environmental income tax**

For tax years beginning after December 31, 2013, and before January 1, 2024, the administration’s FY 2014 proposal would reinstate the corporate environmental income tax that was imposed before 1996.

The corporate environmental income tax was imposed at a rate of 0.12% on the amount by which the modified alternative minimum taxable income (AMTI) of a corporation exceeded $2 million. Modified AMTI was defined as a corporation’s alternative minimum taxable income, determined without regard to the alternative minimum tax net operating loss deduction and the deduction for the corporate environmental income tax.

The tax would be dedicated to the Hazardous Substance Superfund.

**Increase the tobacco tax**

For periods beginning after December 31, 2013, the administration’s FY 2014 proposal would increase the taxes imposed on cigarettes to approximately $1.95 per pack and increase all other excise taxes on tobacco products and cigarette papers and tubes by
roughly the same proportion. Thereafter, these rates would be increased for inflation annually.

Currently, an excise tax is imposed on the following tobacco products and cigarette papers and tubes that are manufactured in or imported into the United States:

- Certain cigars and cigarettes at a rate that varies from $50.33 ($1.01 per pack of 20) to $105.69 per thousand
- Certain cigarette papers and cigarette tubes at a rate that varies from $0.0315 to $0.0630 for each 50 papers or tubes (or fractional part thereof)
- Certain smokeless tobacco, pipe tobacco, and roll-your-own tobacco at a rate that varies from $.5033 to $24.78 per pound (and a proportionate tax at the like rate on all fractional parts of a pound)

The proposal also includes a one-time floor stocks tax that generally applies to tobacco products (other than large cigars), cigarette papers, and tubes that are held for sale on January 1, 2014, and clarifies the definition of roll-your-own tobacco.

Make unemployment insurance surtax permanent

The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6% of the first $7,000 paid annually to each employee. The tax funds a portion of the federal state unemployment benefits system. States also impose an unemployment tax on employers. Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4%, making the minimum net federal tax rate 0.6%. Generally, federal and state unemployment taxes are collected quarterly and deposited in federal trust fund accounts.

Before July 1, 2011, the federal payroll tax had included a temporary surtax of 0.2%, which was added to the permanent FUTA tax rate. The surtax had been extended several times since its enactment in 1976, but it expired on July 1, 2011.

The administration’s FY 2014 proposal would reinstate the 0.2% surtax and make it permanent.

The provision would be effective for wages paid on or after January 1, 2014.

Provide short-term tax relief to employers and expand federal unemployment tax act (FUTA) base

The administration’s FY 2014 proposal would provide short-term relief to employers by suspending interest payments on state unemployment insurance (UI) debt and suspending the FUTA credit reduction for employers in borrowing states in 2013 and 2014. The proposal would also raise the FUTA wage base in 2016 to $15,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net federal UI tax from 0.8% (after the proposed permanent reenactment
and extension of the FUTA surtax) to 0.37%. States with wage bases below $15,000 would need to conform to the new FUTA base. States would maintain the ability to set their own tax rates, as under current law.

The provision would be effective upon the date of enactment.

**Tax carried (profits) interests as ordinary income**

The administration’s FY 2014 proposal includes a measure to tax carried interests in investment partnerships as ordinary income, effective for tax years ending after December 31, 2013. The proposal appears similar in many respects to a proposal that was included in the administration’s budget for the previous fiscal year (FY 2013).

The Green Book generally indicates that the administration’s proposal: (1) would tax as ordinary income a partner’s share of income from an investment services partnership interest (ISPI) in an investment partnership; (2) would require the partner to pay self-employment taxes on such income; and (3) generally would treat gain recognized on the sale of such interest as ordinary. An ISPI generally would be a carried interest in an investment partnership that is held by a person who provides services to the partnership.

A partnership would be an investment partnership only if: (1) substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership’s contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business.

The administration’s proposal provides exceptions for invested capital. Invested capital generally is money or other property that a partner has contributed to the partnership, not including capital that is attributable to the proceeds of loans or advances made or guaranteed by other partners or by the partnership. The proposal also includes anti-abuse rules applicable to certain “disqualified interests.”

The Green Book indicates that, “to ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder."

**Eliminate the deduction for contributions of charitable conservation easements on golf courses**

The administration’s FY 2014 proposal would amend the charitable contribution deduction rules to prohibit a deduction for any contribution of an easement on property that is, or is intended to be, used as a golf course.
Restrict deductions and harmonize the rules for contributions of conservation easements for historic preservation

The administration’s FY 2014 proposal would amend the charitable contribution deduction rules to disallow 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.

Require non-spouse beneficiaries of deceased individual retirement account or annuity (IRA) owners and retirement plan participants to take inherited distributions over no more than five years

Under the administration’s FY 2014 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five years. Exceptions would be provided for eligible beneficiaries. Eligible beneficiaries include any beneficiary who, as of the date of death, is (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant; or (4) an IRA owner or a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner. However, in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

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

The provision would be effective for distributions with respect to plan participants or IRA owners who die after December 31, 2013. The requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary’s death would also apply to participants or IRA owners who die before January 1, 2014, but only if the beneficiary dies after December 31, 2013. The provision would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

Limit the total accrual of tax-favored retirement benefits

Under the administration’s FY 2014 proposal, a taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum
annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of $205,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant’s spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 is approximately $3.4 million.

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

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

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).
The provision would be effective with respect to contributions and accruals for years beginning on or after January 1, 2014.

**TAX GAP AND OTHER REFORMS**

**Require information reporting for private separate accounts of life insurance companies**

The administration’s FY 2014 proposal would require life insurance companies to report to the IRS—for each contract with cash value that is partially or wholly invested in a private separate account for any portion of the tax year and represents at least 10% of the value of the account—(1) the policyholder’s taxpayer identification number; (2) the policy number; (3) the amount of accumulated untaxed income; (4) the total contract account value; and (5) the portion of that value that was invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies with cash values, in the aggregate, of at least 10% of the value of the separate account. Whether a related group of persons owns policies with cash values at 10% or greater of the account value would be determined quarterly, based on information reasonably within the contract issuer's possession.

The provision would be effective for tax years beginning after December 31, 2013.

**KPMG observation**

This proposal is designed to address tax avoidance, and refers to possible application of the “investor control” doctrine. The proposal would impose quarterly account monitoring and additional reporting burdens on life insurance companies.

This provision was included in the administration’s FY 2012 and FY 2013 revenue proposals.

**Require Form W-9 from contractors**

In general, a reportable payment made in the course of a trade or business to a service provider is not subject to withholding if the service provider furnishes a taxpayer identification number (TIN) to the payor prior to the time payment is made.

The administration’s FY 2014 proposal would require service providers to furnish their TINs on Form W-9, thereby certifying as to the correctness of their TINs. Service recipients would be required to verify the accuracy of the TIN with the IRS (through the IRS TIN matching program). Service providers that fail to furnish a certified TIN that matches IRS records would be subject to backup withholding. Alternatively, service providers could request (and require) the service recipient to withhold a flat-rate percentage (selected by the service provider) of the gross payment made.
The provision would be effective for payments made to contractors after December 31, 2013.

**Modify reporting of tuition expenses and scholarships on Form 1098-T**

The administration’s FY 2014 proposal would require institutions of higher learning to report amounts paid rather than amounts billed on Form 1098-T, which is used to verify education spending for education-related tax credits. The proposal would also require any entity issuing a scholarship or grant in excess of $500 (indexed for inflation) that is not processed or administered by an institution of higher learning to report the scholarship or grant on Form 1098-T.

Currently, institutions of higher learning have the choice of reporting payments received for qualified tuition and related expenses or amounts billed for such expenses. Although most entities choose to report amounts billed, only amounts paid in a tax year qualify for a tax credit. Furthermore, scholarships or grants that are paid directly to students are not reported on Form 1098-T. The Green Book states that the proposal will assist taxpayers in preparing their returns and will allow the IRS to monitor and improve compliance.

**Require greater electronic filing of returns**

Corporations with less than $10 million in assets and fewer than 250 returns (including information returns) per year are not required to file electronically. Under the administration’s FY 2014 proposal, all corporations and partnerships required to file Schedule M-3 (the net income (loss) reconciliation schedule) would be required to file their returns electronically. For other large entities not required to file Schedule M-3 (such as exempt organizations), Treasury would be authorized to issue regulations to expand e-filing by reducing the 250-returns-per-calendar-year threshold requirement. Any reduction would need to balance the benefits of electronic filing against any burden that might be imposed on taxpayers.

The provision would be effective for tax years ending after December 31, 2013.

**Make e-filing mandatory for exempt organizations**

The administration’s FY 2014 proposal would require that all Form 990 series tax and information returns be filed electronically and would require the IRS to make the electronically filed Form 990 series returns publicly available in a machine readable format in a timely manner.

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 give
the IRS discretion to delay the effective date for Form 990-T filers for up to three tax years.

Authorize the Department of the Treasury to require additional information to be included in electronically filed Form 5500 annual reports

The administration’s FY 2014 proposal would provide the IRS with the authority to require in the electronically filed Forms 5500 the inclusion of information that is relevant only to employee benefit plan tax requirements, giving the IRS authority to have tax information similar to that the Department of Labor (DOL) already has with respect to information relevant to ERISA Title I.

The provision would be effective for plan years beginning after December 31, 2013.

Implement standards clarifying when employee leasing companies can be held liable for their clients’ federal employment taxes

Liability for federal employment taxes generally falls on the employer under a multi-factor common law test or under specific statutory provisions. Use of an employee leasing company can create uncertainty as to which entity is the employer for employment tax purposes. The administration’s FY 2014 proposal would establish standards for holding employee leasing companies jointly and severally liable with their clients for federal employment taxes, and in some cases, solely liable.

The provision would be effective for employment tax returns required to be filed with respect to wages paid after December 31, 2013.

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 2014 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 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 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 provision 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**

The general aim of the proposal is to allow for the proper classification of workers prospectively. This approach is consistent with the IRS Classification Settlement Program (in place since 1996) and Voluntary Classification Settlement Program (in place since 2011), which allow qualifying employers to pay a relatively modest charge for past years’ misclassifications if the employer agrees to change the status of the workers to employees prospectively.

**Repeal special estimated tax payment provision for certain insurance companies**

The administration’s FY 2014 proposal would repeal section 847, effective for tax years beginning after December 31, 2013. The entire balance of any existing special loss discount account would be included in gross income for the first tax year beginning after December 31, 2013, and the entire amount of existing special estimated tax payments (SETPs) would be applied against additional tax that is due as a result of the provision. Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.

In lieu of immediate inclusion in gross income of the full special loss discount account balance for the first tax year beginning after December 31, 2013, taxpayers could elect to include the amount in gross income ratably over a four-tax-year period, beginning with the first tax year beginning after December 31, 2013. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of the income inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

**KPMG observation**

This provision, which is revenue neutral and is designed to reduce recordkeeping burdens, was included in the administration’s FY 2011 through FY 2013 revenue proposals.
Impose liability on shareholders participating in “Intermediary Transaction Tax Shelters” to collect unpaid corporate income taxes

The administration’s FY 2014 proposal would add a new provision to the Code designed to impose liability on shareholders who engage in “Intermediary Transaction Tax Shelters.”

Previously, the IRS and Treasury identified Intermediary Transaction Tax Shelters as listed transactions that require disclosure on a tax return to avoid certain penalties. Intermediary Transaction Tax Shelters typically involve: (1) a sale of a controlling interest (at least 50%) in the stock of a C corporation; (2) that is undertaken as part of a plan; (3) to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation’s stock. The C corporation is ultimately left with insufficient assets from which to pay the tax owned from the asset sale. This would occur, for example, when sales proceeds from the asset sale are used to repay acquisition financing.

Despite the IRS identifying such transactions as listed transactions, taxpayers continue to engage in these transactions due to the federal government’s inability to efficiently collect the unpaid taxes, interest, additions to tax, or penalties owed by a C corporation that has insufficient assets to pay such amounts. Specifically, the proposal notes that under current law, outside of the consolidated return context, when a C corporation fails to pay income taxes, the federal government is often unable to collect amounts owed by the C corporation from its former shareholders.

The administration’s FY 2014 proposal would create a new provision that would impose liability on shareholders who enter into Intermediary Transaction Tax Shelters. Specifically, the proposal would apply to shareholders who, pursuant to a plan, directly or indirectly, dispose of a controlling interest (at least 50%) in the stock of a C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the C corporation. Such liability would be imposed only after the C corporation is assessed income taxes and penalties and fails to pay such amounts within a specified time period. The amount of the shareholder’s liability would be limited to the lesser of: (1) the value of the total proceeds received by the shareholder on disposition of the stock of the C corporation; or (2) the income tax liability the C corporation would have had if it had liquidated in a fully taxable transaction on the date that at least 50% of its stock was sold subject to certain adjustments for income tax paid, as well as penalties and interest owed by the C corporation within a specified time period.

The provision would not apply to the disposition of certain publicly traded corporations or publicly traded RICs or the acquisition by a publicly traded entity or an entity that is consolidated for financial reporting purposes with a publicly traded entity.
The provision would also include certain procedural rules that appear to be intended to facilitate the federal government’s ability to collect from the C corporation and the former shareholders.

The provision would be effective upon enactment.

**Increase levy authority for payments to Medicare providers with delinquent tax debt**

Under the *Medicare Improvement for Patients and Providers Act of 2008*, Treasury is authorized to continually levy up to 15% of a payment to a Medicare provider in order to collect a delinquent tax debt. Certain Medicare providers fail to comply with their federal income tax and/or employment tax obligations.

The administration’s FY 2014 proposal would allow Treasury to levy up to 100% of a payment to a Medicare provider to collect unpaid taxes. This would assist in recovering a greater amount of delinquent taxes and would promote providers’ compliance with their federal tax obligations.

The proposal would be effective for payments made after the date of enactment.

**Implement a program integrity statutory cap adjustment for tax administration**

Previous administrations and Congresses have used a budget mechanism called “a program integrity cap adjustment” to increase congressional allocations for annual budget appropriations. Under the mechanism, funding above the spending ceiling that is specified in the annual congressional appropriations process is granted for specified “program integrity” purposes. This process has been critical in maintaining the IRS enforcement and compliance functions, allowing the IRS to initiate new programs that generate high returns on investment, and encouraging taxpayers to comply with the tax laws.

The administration’s FY 2014 proposal would make an adjustment to the discretionary spending limits for IRS tax enforcement, compliance, and related activities. These resources would help the IRS continue to target international tax compliance, identify and prevent refund fraud, and restore previously reduced enforcement levels.

**Streamline audit and adjustment procedures for large partnerships**

The IRS encounters many auditing and adjustment problems for partnerships that have a large number of partners. The *Tax Equity and Fiscal Responsibility Act of 1982* (TEFRA) established certain rules applicable to all but certain small partnerships. The purpose of the TEFRA partnership rules is to provide consistent treatment of partnership items among all partners on both partnership returns and partnership audits, and to lessen the administrative and judicial burdens placed on the government. The *Tax Relief Act of 1997* established a second streamlined audit and adjustment
procedure for a large partnership, as well as a simplified reporting system for partnerships that have 100 or more partners during the preceding tax year and that elect to be treated as an electing large partnership (ELP).

According to the Green Book, the present TEFRA partnership procedures remain inefficient and more complex than those applicable to other large entities. Further, few large partnerships have elected into the ELP regime, which was intended to mitigate the problems associated with large partnerships.

The administration’s FY 2014 proposal would mandate the ELP audit and adjustment procedures, but not simplified reporting, for any partnership that has 1,000 or more partners at any time during the tax year—a required large partnership (RLP).

Under the ELP audit and adjustment procedures, the IRS generally makes adjustments at the partnership level that flow through to the partners for the year in which the adjustment takes place. Thus, the current-year partners’ share of current-year partnership items of income, gains, losses, deductions, or credits are adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally will not affect prior-year returns of any partner (except in the case of changes to any partner’s distributive shares.) Unlike the TEFRA partnership rules, only the partnership can request a refund, and the partners of an ELP do not have the right to participate in partnership-level proceedings. The IRS is not required to give notice to the partners of the beginning of an administrative proceeding or of a final partnership adjustment. Under the ELP audit rules, the notice of partnership adjustments is generally sent to the partnership and only the partner designated by the partnership act on behalf of the partnership.

An RLP, like an ELP, would not include any partnership if substantially all of the partners are: (1) individuals performing substantial services in connection with the partnership’s activities, or personal service corporations the owner-employees of which perform services; (2) retired partners who had performed those services; or (3) spouses of partners who had performed those services.

For purposes of determining whether a partnership has 1,000 or more partners, any person that owns an interest directly or indirectly in the partnership through one or more pass-through partners is treated as a partner. Any partnership, estate, trust, S corporation, nominee, or other similar pass-through person would be required to provide to the lower-tier pass-through person the information necessary for the lower-tier pass-through person to determine the number of owners that the pass-through person has.

An RLP will continue to be treated as an RLP unless it can demonstrate that the number of partners fell below the 1,000-partner threshold for the 60-month period ending with the last day of its most recently ended tax year. An RLP may elect to continue to be an RLP. In addition, a partnership that has 100 or more partners at any time during the year may elect to be an RLP. Any election to be an RLP cannot be revoked for any year without the consent of the Treasury Secretary.
A partnership would be required to certify that it had at least 1,000 partners at some point during the tax year by filing an RLP return. The treatment provided by the certification would be binding on the partnership, all partners of the partnership, and on the IRS. If a partnership incorrectly filed an RLP return, the RLP procedures would apply for that tax year. If a partnership incorrectly failed to file an RLP return, the TEFRA partnership audit procedures would continue to apply for that year and the period of limitations on assessment would not expire before the date that is three years after the date the RLP return was to have been filed. In addition, the partnership would be treated as an RLP for the partnership’s tax year ending on or after the date the IRS determines and notifies the partnership that an RLP return was to have been filed.

A very significant penalty could be imposed for a failure to file a proper RLP return. The partnership would be liable for a penalty equal to the product of $5,000 multiplied by the number of direct and indirect partners of the partnership, unless it establishes that there was reasonable cause for, and the partnership acted in good faith with respect to, incorrectly failing to file the proper return.

The provision would be effective for a partnership’s tax year ending on or after the date that is two years from the date of enactment.

**Revise offer-in-compromise application rules**

The administration’s FY 2014 proposal would repeal a 2006 provision that requires an offer-in-compromise applicant to make certain non-refundable payments as part of its application.

The provision would be effective for offers in compromise submitted after the date of enactment.

**Expand IRS access to information in the National Directory of New Hires for tax administration purposes**

The Department of Health and Human Services maintains the national directory of new hires (NDNH), a database of new-employee data from Form W-4, quarterly wage data from state and federal employment security agencies, and unemployment benefit data from state unemployment insurance agencies. The administration’s FY 2014 proposal would amend the Social Security Act to expand IRS access to NDNH data for general tax administration purposes. Data obtained by the IRS from the NDNH would be protected by existing taxpayer privacy law, including civil and criminal sanctions.

The provision would be effective upon enactment.
Make repeated willful failure to file a tax return a felony

Under the administration’s FY 2014 proposal, any person who willfully fails to file tax returns for three years within any five consecutive year period—if the aggregate tax liability for such period is at least $50,000—would be subject to an aggravated failure to file criminal penalty of not more than $250,000 ($500,000 in the case of a corporation) or imprisonment for not more than five years or both. The felony penalty would replace the current misdemeanor penalty.

The penalty would be effective for returns required to be filed after December 31, 2013.

Facilitate tax compliance with local jurisdictions

Although tax returns and return information generally are confidential, the IRS and Treasury may share information with states and certain local governmental entities that are treated as states for this purpose. Indian tribal governments are treated as states for several purposes, including certain charitable contributions, excise tax credits, and local tax deductions, but not for information sharing purposes.

Under the administration’s FY 2014 proposal, Indian tribal governments that impose alcohol, tobacco, or fuel excise taxes or income or wage taxes would be treated as states for purposes of information sharing to the extent necessary for tax administration. A tribal government that receives tax information would be required to safeguard it according to prescribed protocols. Criminal and civil sanctions would apply.

The provision would be effective for disclosures made after the date of enactment.

Extend statute of limitations when state adjustment affects federal tax liability

The administration’s FY 2014 proposal would create an exception to the three-year statute of limitations for assessment of federal tax liability when the assessment is the result of adjustments to state or local tax liabilities. The statute of limitations would be extended to the greater of: (1) one year from the date the taxpayer files an amended tax return with the IRS reflecting adjustments to the state or local tax return; or (2) two years from the date the IRS receives information from the state or local revenue agency under an information sharing agreement. The statute would be extended only with respect to the increase in federal tax attributable to the state or local tax adjustment. The statute of limitations on claims for refund would be extended correspondingly so that any overall increase in tax assessed by the IRS as a result of the state or local examination report would take into account agreed-upon tax decreases or reductions attributable to a refund or credit.

The provision would be effective for returns required to be filed after December 31, 2013.
Improve investigative disclosure statute

Taxpayer privacy would be clarified under the administration’s FY 2014 proposal by stating that it does not prohibit Treasury and IRS officers and employees from identifying themselves, their organizational affiliation, and the nature and subject of an investigation, when contacting third parties in connection with a civil or criminal tax investigation.

The provision would be effective for disclosures made after enactment.

Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a 2-D bar code

Taxpayers can currently prepare their tax returns electronically (either by utilizing a tax return preparer or using tax return software at home) and, instead of filing their returns electronically, may print out a paper copy and file the returns on paper by mailing it to the IRS.

The administration’s FY 2014 proposal would require all taxpayers who prepare their tax returns electronically, but print their returns and file them on paper, to print their returns with a 2-D bar code that can be scanned by the IRS to convert the paper return into an electronic format.

The provision would be effective for tax returns filed after December 31, 2013.

Allow the IRS to absorb credit and debit card processing fees for certain tax payments

Currently, the IRS allows a taxpayer to make credit or debit card payments in certain circumstances, but the providers charge the taxpayer a convenience fee over and above the taxes due.

The administration’s FY 2014 proposal would amend section 6311 to allow, but not require, the IRS to accept credit or debit card payments directly from taxpayers and to absorb the credit and debit card processing fees for delinquent tax payments, without charging a separate processing fee to the taxpayer.

The provision would be effective for payments made after the date of enactment.

Extend IRS math error authority in certain circumstances

In general, if the IRS determines that there is a deficiency, the IRS issues a statutory notice of deficiency and the taxpayer is provided an opportunity to challenge the proposed deficiency in the U.S. Tax Court before the deficiency is assessed.
Section 6213(b) provides an exception from the general deficiency procedures by granting the IRS authority to correct certain mathematical or clerical errors made on tax returns, i.e., math error authority. “Mathematical and clerical error” is defined in section 6213(g)(2) and includes, for example, errors in addition, subtraction, multiplication, or division shown on the return or an entry on a return of an item that is inconsistent with another entry of the same or another item on the return.

The administration’s FY 2014 proposal would add two items to the list of circumstances when the IRS has math error authority: (1) a taxpayer claimed a deduction or credit in excess of a lifetime limit; or (2) a taxpayer claimed the earned income tax credit (EITC) during a period of disallowance under section 32(k).

This provision would be effective for tax years beginning after December 31, 2013.

**Impose a penalty on failure to comply with electronic filing requirements**

A return that is required to be e-filed but is instead filed on paper can be treated as a failure to file, but no penalty may result if the corporation is in a refund, credit or loss position (as the penalty is based on the underpayment of tax). The administration’s FY 2014 proposal would establish an assessable penalty for a failure to comply with a requirement of electronic (or other machine-readable) format for a return that is filed. The penalty would be $25,000 for a corporation and $5,000 for a tax-exempt organization.

The penalty would be effective for returns required to be electronically filed after December 31, 2013.

**Restrict access to the Death Master File (DMF)**

The DMF is a list of deceased individuals maintained by the Social Security Administration (SSA) that is updated weekly. SSA created the DMF in response to a 1980 consent judgment that requires SSA to provide certain personally identifiable information about deceased individuals under the Freedom of Information Act. The DMF contains the full name, Social Security number (SSN), date of birth, date of death, and the county, state, and zip code of the last address on record for decedents. This information is publicly available and, pursuant to the consent judgment, released weekly by SSA, and many websites publish the information included on the DMF free or for a nominal fee.

The administration’s FY 2014 proposal would limit immediate access to the DMF to those users who legitimately need the information, for fraud prevention purposes, and to delay the release of the DMF for three years to all other users.

The proposal would be effective upon enactment.
Provide whistleblowers with protection from retaliation

Section 7623 allows whistleblowers to file claims for an award for information that allowed the IRS to detect tax underpayments or detect and bring to trial and punishment persons guilty of violating the internal revenue laws.

Other whistleblower statutes, such as the False Claims Act, explicitly provide whistleblowers with protection from retaliatory actions and allow whistleblowers to file claims in U.S. district courts for relief, including reinstatement, back pay, and other damages. There are currently no protections from retaliatory action for whistleblowers who file claims under section 7623. This lack of protection from retaliation may discourage whistleblowers from filing claims with the IRS.

The administration’s FY 2014 proposal would amend section 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act.

The proposal would be effective upon enactment.

Provide stronger protection from improper disclosure of taxpayer information in whistleblower actions

Section 6103 provides that tax returns and tax return information are confidential, unless an exception applies. Section 6103(p) imposes safeguarding requirements on certain disclosures of tax return information. In addition, civil and criminal penalties may be imposed on an unauthorized inspection or disclosure of tax return information.

Currently, the IRS Whistleblower Office may share tax return information with whistleblowers and their legal representatives in a whistleblower administrative proceeding under section 6103(h) or by entering into a written agreement with the IRS under section 6103(n). Whistleblowers and their representatives who receive tax return information under section 6103(n) are subject to the section 6103(p) safeguarding requirements, including civil and criminal penalties for unauthorized inspections and disclosures. The same section 6103(p) safeguards do not extend to information disclosed to whistleblowers under section 6103(h).

The administration’s FY 2014 proposal would extend the section 6103(p) safeguarding requirements to whistleblowers and their legal representatives for information disclosed under section 6103(h). In addition, the proposal extends the penalties to unauthorized inspections and disclosures of tax return information to whistleblowers and legal representatives.

The proposal would be effective upon enactment.
Index all penalties to inflation

The Code currently contains numerous penalty provisions in which a fixed penalty amount was established when the penalty was initially added to the Code. These provisions contain no mechanism to adjust the amount of the penalty for inflation, and thus, these penalties are only increased by amending the Code.

The administration’s FY 2014 proposal would index all penalties to inflation and round the indexed amount to the next hundred dollars.

The proposal would be effective upon enactment.

Extend paid preparer earned income tax credit (EITC) due diligence requirements to the child tax credit

Currently, paid preparers who prepare federal income tax returns that involve an EITC must meet certain due diligence requirements or face a penalty of $500 for each return for which the requirement was not met. For each tax return, a paid preparer must complete the Paid Preparer’s Earned Income Credit Checklist (Form 8867) and the checklist must be filed with the taxpayer’s return. The paid preparer is also responsible for fulfilling record-keeping requirements.

To meet the due diligence requirements, preparers must complete the checklist based on current and reasonable information. Preparers must also complete the EITC worksheet found in the Form 1040 instructions (or complete a comparable worksheet of their own creation). Finally, preparers must take steps to determine that all taxpayer information provided to them is correct and complete by asking follow-up questions to the taxpayer and requesting additional documentation. Preparers must keep a copy of all forms, a record of any additional questions asked and taxpayer’s answers, and other information for three years.

The eligibility requirements for the child tax credit, including the definition of a qualifying child, are similar to the eligibility requirements for the EITC. However, paid preparers do not face a similar due diligence requirement for the child tax credit.

The administration’s FY 2014 proposal would extend the due diligence requirement to include all federal income tax returns that claim the child tax credit, including the additional child tax credit. The existing checklist would be expanded and adapted to reflect the differences in requirements between the EITC and the child tax credit, while providing that the additional burden to preparers and filers is minimized.

The proposal would be effective for tax years beginning after December 31, 2013.
Extend IRS authority to require a truncated social security number (SSN) on Form W-2

Currently, employers are required to include an employee’s SSN on the copy of Form W-2 furnished to employees. Other information returns provided to taxpayers, such as Forms 1099, are subject to more general rules that require the taxpayer’s “identifying number” to be reported on the information return. When an identifying number is required, Treasury and the IRS have regulatory authority to permit filers to use a number other than the taxpayer’s SSN. In an effort to combat identity theft, Treasury and the IRS have permitted filers of certain information returns to truncate a taxpayer’s identifying number, including an SSN, on the information return copy provided to the taxpayer.

The administration’s FY 2014 proposal would require employers to include an “identifying number” for each employee, rather than an employee’s SSN, on Form W-2. This would allow Treasury and the IRS to exercise regulatory authority to require or permit a truncated SSN on Form W-2.

The proposal would be effective upon enactment.

Add tax crimes to the aggravated identity theft statute

The “aggravated identity theft statute” permits an increased sentence when the identity of another individual is used to commit certain crimes, which currently does not include any tax crimes. A conviction for aggravated identity theft adds two years to the sentence imposed for the underlying felony.

The administration’s FY 2014 proposal would subject certain tax-related crimes to the “aggravated identity theft statute.”

The proposal would be effective upon enactment.

Impose a civil penalty on tax identity theft crimes

From 2008 through May 2012, the IRS identified over 550,000 taxpayers who were affected by identity theft. Current law does not impose a civil penalty for tax-related identity theft.

The administration’s FY 2014 proposal would add a $5,000 civil penalty on individuals who file a fraudulent return in connection with a tax identity theft case. Under the proposal, the IRS would be able to immediately assess a separate civil penalty for each incidence of identity theft, with no limit on the penalty amount imposed.

The proposal would be effective upon enactment.
SIMPLIFICATION

Simplify the rules for claiming the EITC for workers without qualifying children

Under current law, certain taxpayers with low wages who do not have any qualifying children may still be eligible to claim an EITC, in a smaller amount than for workers with qualifying children. However, such a taxpayer is allowed no EITC if he or she resides with a qualifying child whom the taxpayer does not claim as a qualifying child (because, for example, the child is claimed by another individual in the household).

The administration’s FY 2014 proposal would allow otherwise eligible taxpayers to claim the EITC when such taxpayers reside with children whom they do not claim.

Eliminate minimum required distribution (MRD) rules for IRA plan balances of $75,000 or less

The administration’s FY 2014 proposal would exempt an individual from the MRD requirements if the aggregate value of the individual’s IRA and tax-favored retirement plan accumulations does not exceed $75,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase in ratably for individuals with aggregate retirement benefits between $75,000 and $85,000.

The provision would be effective for taxpayers attaining age 70½ years on or after December 31, 2013.

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

The administration’s FY 2014 proposal would expand the option available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited-plan or IRA assets by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The provision would be effective for distributions after December 31, 2013.

Repeal non-qualified preferred stock (NQPS) designation

The administration’s FY 2014 proposal would remove from the Code the designation NQPS and the treatment of such stock as “boot.”

Section 351(g) excepts from the general nonrecognition rule of section 351 transfers of property to a corporation in exchange for NQPS of that corporation. NQPS is stock that: (1) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (2) has a dividend rate that varies with reference to an index, or in certain circumstances, a put right, call right, or a mandatory redemption
feature. NQPS may also be treated as boot if it is received in certain shareholder exchanges pursuant to a plan of reorganization.

The proposal would repeal the NQPS provision in section 351 (and any other cross-referencing provision of the Code that references NQPS) for stock issued after December 31, 2013.

The proposal notes that NQPS is commonly used in corporate tax planning in a variety of ways. For example, the transfer of an asset with a built-in loss to a controlled corporation in exchange for NQPS of that corporation generally allows the transferor to recognize the loss (subject to loss limitation rules such as section 267) and to avoid the general nonrecognition rule of section 351. In addition, the use of NQPS to acquire stock of a related party may help avoid deemed dividend treatment that might otherwise result from a related-party stock purchase under section 304.

In enacting the NQPS provisions in 1997, Congress recognized that certain types of preferred stock more appropriately represented taxable consideration because the transferor obtained a more secure form of investment. The administration’s FY 2014 proposal embodies a belief that transactions such as those described above may be either inconsistent with Congress’s original intent in enacting the provision and/or may otherwise add unnecessary complexity.

**KPMG observation**

The reference in the administration’s FY 2014 proposal to the use of NQPS in related-party stock sales to avoid deemed dividend treatment is interesting in light of the fact that all stock (whether NQPS or otherwise) is not “property” for purposes of section 304. Thus, it would seem that any stock (regardless of its classification as NQPS or otherwise) may be used to avoid section 304. However, if this change is enacted, NQPS could no longer be used to avoid both section 304 deemed dividend treatment and section 351 nonrecognition treatment with respect to the same transfer if section 351 would be applicable. Thus, the proposal, if enacted, would still limit tax planning opportunities (as well as protect taxpayers from inadvertently planning into a taxable exchange) related to the use of NQPS in related-party stock sales.

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

The administration’s FY 2014 budget proposal would repeal the preferential dividend rule for publicly traded REITs and publicly offered REITs. That is, the preferential dividend rule would not apply to a distribution with respect to stock if:

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

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

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

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

**Reform excise tax based on investment income of private foundations**

The administration’s FY 2014 proposal would replace the two rates of tax on private foundations that are exempt from federal income tax with a single tax rate of 1.35%. The tax on private foundations not exempt from federal income tax would be equal to the excess (if any) 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 income tax imposed on the foundation. The special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions would be repealed.

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

**Remove bonding requirements for certain taxpayers subject to federal excise taxes on distilled spirits, wine and beer**

Effective 90 days after the date of enactment, the administration’s FY 2014 proposal would require a taxpayer subject to the excise tax on any distilled spirits, wines, and beer and who reasonably expects to be liable for not more than $50,000 per year in alcohol excise taxes (and who was liable for not more than $50,000 of such taxes in the preceding calendar year) to file and pay such taxes quarterly, rather than semi-monthly. The proposal would also create an exemption from the bond requirement in the Code for these taxpayers. The proposal includes conforming changes to the other sections of the Code describing bond requirements. Additionally, the proposal would allow a taxpayer subject to the excise tax on any distilled spirits, wine, and beer with a reasonably expected alcohol excise tax liability of not more than $1,000 per year to file and pay such taxes annually rather than on a quarterly basis. The proposal will create parity among alcohol taxpayers by allowing eligible distilled spirits and beer taxpayers to file annually as well.
Exclude self-constructed assets of small taxpayers from the UNICAP rules

The administration’s FY 2014 proposal would exempt certain small producers from the application of the uniform capitalization (UNICAP) rules for costs incurred to produce real or personal property to be used by the taxpayer in its trade or business. Under current law, taxpayers that produce property for use in their trade or business, or produce or acquire property for resale, are generally required to capitalize the direct and indirect costs of the property produced or acquired. Costs required to be capitalized include direct costs of property produced, a proper share of certain indirect costs allocable to the property produced, and in certain cases, allocable interest costs.

The UNICAP rules contain certain exceptions, including the following:

- Personal property acquired by a taxpayer for resale is not subject to the UNICAP rules if the average annual gross receipts of the taxpayer do not exceed $10 million;
- Producers with de minimis total indirect costs ($200,000 or less) are not required to capitalize indirect costs in excess of those capitalized for financial accounting purposes; and
- Certain other rules exempt produced inventory of certain small producers from the UNICAP capitalization requirements.

The proposal would exempt taxpayers having average annual gross receipts of $10 million or less from the application of the UNICAP rules for costs incurred to produce real or personal property for use by the taxpayer in its trade or business. Average annual gross receipts would be calculated based on the taxpayer’s previous three tax years, and all persons treated as a single employer would be treated as a single taxpayer for purposes of this test. The proposal would be effective for costs incurred in tax years beginning after December 31, 2013.

Repeal technical terminations of partnerships

Under current law, a partnership can “technically terminate” under section 708(b)(1)(B) if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in both partnership capital and partnership profits. If a partnership technically terminates, certain events are deemed to take place to effectuate the tax fiction that the “old” partnership has terminated and a “new” partnership has begun.

The administration’s FY 2014 proposal would repeal the technical termination rule of section 708(b)(1)(B), effective for transfers on or after December 31, 2013. The Green Book indicates that the technical termination provision currently “serves as a trap for the unwary taxpayer or as an affirmative planning tool for the savvy taxpayer,” and cites several unanticipated consequences that can result from a technical termination, including the restart of section 168 depreciation lives, the close of the partnership’s tax year, and the loss of partnership-level elections.
KPMG observation

Technical terminations can raise significant federal tax issues, many of which can be unfavorable from a taxpayer’s perspective, but some of which can be favorable in particular fact situations. In addition, technical terminations raise compliance considerations. As a result, under current law, it can be more important for partnerships to monitor sales and exchanges of their interests to determine if technical terminations may be triggered and to assess the consequences of such terminations based on their particular facts. Repealing the technical termination rules would reduce compliance burdens and would eliminate consequences—favorable and unfavorable—that can result in particular cases.

Repeal anti-churning rules under 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, such intangibles were not amortizable. The anti-churning rules in section 197(f)(9) exclude an asset 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.

This anti-churning provision was enacted to prevent taxpayers from converting existing goodwill, going-concern value, or any other section 197 intangible for which a depreciation or amortization deduction would not have been allowable under pre-1993 law into amortizable property.

The administration’s FY 2014 proposal would repeal the anti-churning rules in section 197(f)(9) effective for acquisitions after December 31, 2013.