President's FY 2014 budget contains host of individual and business tax provisions – April 25, 2013

On April 10, the President released his federal budget proposals for fiscal year 2014. The Treasury Department's “General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals” (the so-called “Green Book”) was released later that day. Among other things, the revenue proposals include proposed tax changes for businesses and individuals and increased IRS funding.

Business Tax Proposals

In his budget, the President called “on Congress to immediately begin work on corporate tax reform that will close loopholes, lower the corporate tax rate, encourage investment here at home, and not add a dime to the deficit.” However, he also introduced a number of specific measures in the budget proposals “as a starting point for comprehensive reform,” including proposals to:

- Effective for qualifying property placed in service in tax years after Dec. 31, 2013, permanently extend increased expensing for small business under Code Sec. 179, with a $500,000 deduction limit and phase-out beginning at $2 million (indexed for inflation for tax years beginning after 2013). Qualifying property would permanently include off-the-shelf computer software, but would not include real property.
- Enhance and make permanent the research tax credit, and increase the rate of the alternative simplified research credit (ASC) from 14% to 17%, effective after Dec. 31, 2012.
- Permanently extend the work opportunity tax credit (WOTC) to wages paid to qualified individuals who begin work after Dec. 31, 2013, and modify the calculation of the credit to equal 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.
- Offer a one-time, temporary 10% tax credit for increases in companies' wage payments over wages paid in 2012, whether driven by new hires, increased wages or salaries, or both. The credit would be available for small businesses—i.e., those with less than $20 million of total wages paid in 2012—for up to $5 million in increased wages. Thus, the maximum credit would be $500,000.
- Require employers that have over 10 employees and do not currently offer a retirement plan to enroll their employees in a direct-deposit Individual Retirement Account (IRA) that is compatible with existing direct-deposit payroll systems. (Employees can opt out if they choose.) Employers would be entitled to a tax credit of $25 per participating employee, up to $250 per year, for six years. Additionally, the budget would double the existing tax credit for small employers that start up new qualifying employer plans. The increased credit amount would be $1,000 per year, and the credit would be available for four years.
- Reform the tax treatment of derivatives by requiring that all derivative contracts be “marked to market,” with resulting gains and losses taxes each year and treated as ordinary income.

- Eliminate special depreciation rules for corporate jets by increasing the depreciation period from five to seven years, consistent with the treatment of commercial aircraft.
- Restructure the Federal wage reporting process by moving from annual to quarterly wage reporting.
- Lower the Electronic Wage Reporting Threshold for W-2/3s from 250 employees to 50.
- Permanently extend and modify the New Markets Tax Credit (NMTC), currently set to expire on Dec. 31, 2013, with an allocation amount of $5 billion for each round.
- Effective after Dec. 31, 2013, provide tax credits to New York State and New York City for expenditures relating to the construction or improvement of transportation infrastructure in or connecting to the New York Liberty Zone. The tax credit would be allowed in each year from 2014 to 2023, inclusive, subject to an annual limit of $200 million.
- Effective after the date of enactment, reform and expand the low-income housing tax credit (LIHTC) by, among other things: allowing states to convert private activity bond (PAB) volume cap into LIHTCs that the state can allocate; allowing LIHTC-supported projects to elect a criterion employing a restriction on average income; and making the LIHTC beneficial to real estate investment trusts (REITs) and regulated investment companies (RICs).
- Employers currently pay FUTA tax at a rate of 6.0% on the first $7,000 of covered wages paid annually to each employee. Employers in States that meet certain Federal requirements are allowed a credit against FUTA taxes of up to 5.4%, making the minimum net Federal rate 0.6%. States that become non-compliant are subject to a reduction in FUTA credit, causing employers to face a higher Federal UI tax. Effective on the enactment date, the budget would provide short-term relief by suspending interest payments on the State UI debt and suspending the FUTA credit reduction for employers in borrowing States in 2013 and 2014. Other changes would be made. For example, the FUTA wage base would be raised in 2016 to $15,000 per worker.
- Repeal the last-in, first-out (LIFO) accounting method, for tax years beginning after Dec. 31, 2013. Taxpayers required to change from the LIFO method also would be required to report their beginning-of-year inventory at its first-in, first-out (FIFO) value in the year of change, causing a one-time increase in taxable income that would be recognized ratably over 10 years.
- For tax years beginning after Dec. 31, 2013, bar the use of the lower-of-cost-or market and subnormal goods methods of inventory accounting, which currently allow certain taxpayers to take cost-of-goods-sold deductions on certain merchandise before the merchandise is sold. Any resulting income inclusion would be recognized over a four-year period beginning with the change year.
- Repeal the “boot-within-gain” limitation for dividends received in reorganization exchanges.
- Expand the definition of “built-in loss” for purposes of partnership loss transfers.
- Limit the importation of losses under related party loss limitation rules.
- Deny deductions for punitive damages.

- For qualified small business stock (QSBS) acquired after Dec. 31, 2013, make the 100% exclusion for qualified small business stock permanent. The AMT preference item for gain excluded under Code Sec. 1202 would be repealed for all excluded small business stock gain. Also, the time for a taxpayer to reinvest the proceeds of sales of small business stock under Code Sec. 1045 would be increased to 6 months for qualified small business stock the taxpayer has held longer than three years.
- For tax years ending on or after the date of enactment, permanently double the maximum amount of start-up expenditures that a taxpayer may deduct (in addition to amortized amounts) in the tax year in which a trade or business begins from $5,000 to $10,000. This maximum amount of expensed start-up expenditures would be reduced (but not below zero) by the amount by which start-up expenditures with respect to the active trade or business exceed $60,000.
- For tax years beginning after Dec. 31, 2012, expand the group of employers who are eligible for the tax credit available to small employers providing health insurance to employees to include employers with up to 50 full-time equivalent employees, and begin the phase-out at 20 full-time equivalent employees.
- Tax certain “carried interest” as ordinary income, instead of at the 20% capital gains rate.
- Permit IRS to issue generally applicable guidance about the proper classification of workers and to require prospective reclassification of workers who are currently misclassified and whose reclassification is prohibited under current law.

Proposals to Boost U.S. Manufacturing and Insourcing of Jobs

To encourage businesses to locate jobs and business activity in the U.S., the President's budget proposes to make these changes, among others:

- Provide additional tax credits ($2.5 billion) for investment in qualified property used in a qualified advanced energy manufacturing project.
- 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. Insourcing a U.S. trade or business would mean reducing or eliminating a trade or business (or line of business) currently conducted outside the U.S. and starting up, expanding, or otherwise moving the same trade or business within the U.S., to the extent that this action results in an increase in U.S. jobs.
- Disallow deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business. Outsourcing a U.S. trade or business would mean reducing or eliminating a trade or business or line of business currently conducted inside the U.S. and starting up, expanding, or otherwise moving the same trade or business outside the U.S., to the extent that this action results in a loss of U.S. jobs.
- Create of a new allocated tax credit (“manufacturing communities tax credit”) to support investments in communities that have suffered a major job loss event (i.e., 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). About $2 billion in credits would be provided for qualified investments approved in each of the three years, 2014 through 2016.

International Tax System

The President's budget also contained several proposals for reforming the U.S. international tax system, which would generally be effective for transactions in tax years beginning after Dec. 31, 2013. The proposals included to:

1. Defer the deduction of interest expense properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to U.S. tax until such income is subject to U.S. tax.
2. Require a taxpayer to determine foreign tax credits from the receipt of a dividend from a foreign subsidiary on a consolidated (“pooled”) basis for all its foreign subsidiaries. Foreign tax credits from the receipt of a dividend from a foreign subsidiary would be based on the consolidated earnings and profits and foreign taxes of all the taxpayer's foreign subsidiaries.
3. Provide that if a U.S person transfers an intangible to a controlled foreign corporation (CFC), then certain excess income from transactions connected with or benefitting from the covered intangible would be treated as subpart F income if the income is subject to a low foreign effective tax rate.
4. Clarify the definition of intangible property for purposes of the special rules relating to transfers of intangibles by a U.S. person to a foreign corporation (Code Sec. 367(d)) and the allocation of income and deductions among taxpayers (Code Sec. 482) to prevent inappropriate shifting of income outside the U.S.
5. Disallow the deduction for non-taxed reinsurance premiums paid to affiliates.
6. Revise Code Sec. 163(j) to tighten the limitation on the deductibility of interest paid by an expatriated entity to related persons.
7. Modify tax rules for dual capacity taxpayers.
8. Tax gain from the sale of a partnership interest on look-through basis.
9. Prevent use of leveraged distributions from related foreign corporations to avoid dividend treatment.
10. Extend Code Sec. 338(h)(16), which provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is not treated as occurring for purposes of determining the source or character of any item for purpose of applying the foreign tax credit rules to the seller, to certain asset acquisitions.
11. Remove foreign taxes from a Code Sec. 902 corporation's foreign tax pool when earnings are eliminated.

Environmental and Energy-Related Provisions

The President's budget would:

- Make the tax credit for the production of renewable energy permanent and refundable.
- Reform and making permanent the deduction for energy-efficient commercial property.
- Replace the credit for plug-in electric drive motor vehicles with a credit for the production of qualifying “advanced technology vehicles.” The credit would be allowed for vehicles placed in service after Dec. 31, 2013 and before Jan. 1, 2021. The credit would be limited to 75% of the otherwise allowable amount for vehicles placed in service in 2018, 50% of such amount for vehicles placed in service in 2019, and 25% of such amount for vehicles placed in service in 2020.
- Provide a tax credit for qualifying medium and heavy-duty alternative-fuel commercial vehicles, equal to 50% of the incremental cost of such vehicles compared to the cost of a comparable diesel or gasoline vehicle, limited to $25,000 for vehicles weighing up to 26,000 pounds and $40,000 for vehicles weighing more than 26,000 pounds. The credit would be allowed for vehicles placed in service after Dec. 31, 2013, and before Jan. 1, 2020, and would be limited to 50% of the otherwise allowable amount for vehicles placed in service in calendar year 2019.
- Permanently extend and make refundable the renewable electricity production tax credit, and make it available to electricity produced from solar facilities. The refundable credit would be available for property on which construction begins after Dec. 31, 2013.
- Eliminate fossil fuel tax preferences by: repealing the enhanced oil recovery credit, the credit for oil and gas produced from marginal wells, expensing of intangible drilling costs, the deduction for tertiary injectants, the exception to passive loss limitation for working interests in oil and natural gas properties, percentage depletion for oil and natural gas wells, the domestic manufacturing deduction for oil and natural gas production; increasing the geological and geophysical amortization period for independent producers to seven years; and eliminating coal preferences.

Tax Changes for Individuals

The President's plan calls for numerous changes to be made for individuals, including to:

- Reduce the value of itemized deductions and other tax preferences to 28% for families with income in the top three highest tax brackets. This limit would apply to: all itemized deductions; foreign excluded income; tax-exempt interest; employer sponsored health insurance; retirement contributions; and selected above-the-line deductions.
- Observe the “Buffett rule” by requiring millionaires to pay no less than 30% of income (after charitable contributions) in taxes. This would be referred to as the “fair share tax.”
- For tax years beginning after Dec. 31, 2017, permanently extend the American Opportunity Tax Credit (AOTC), a partially refundable tax credit worth up to $10,000 per student over four years of college.

- For tax years beginning after Dec. 31, 2017, permanently extend the increased refundability of the child tax credit (CTC) by permanently reducing the earned income threshold to $3,000.
- Provide for automatic enrollment in IRAs (see above).
- Extend the exclusion from income for cancellation of certain home mortgage debt to amounts that are discharged before Jan. 1, 2016, and amounts that are discharged pursuant to an agreement entered before that date.
- For tax years beginning after Dec. 31, 2017, make permanent the expansion of the EITC for workers with three or more qualifying children by maintaining (i) the phase-in rate of the EITC for workers with three or more qualifying children at 45%, and (ii) the phase-out range for married couples at $5,000 higher than those for unmarried filers (indexed after 2009).
- Increase the child and dependent care credit available to working families with incomes between $15,000 and $103,000.
- Extend the exclusion for income from the discharge of qualified principal residence indebtedness (QRPI) to amounts that are discharged before Jan. 1, 2015, and to amounts that are discharged pursuant to an agreement entered before that date.
- Prohibit individuals from accumulating over $3 million in tax-preferred retirement accounts.

Estate and Gift Tax Proposals

The President's budget would also:

- Beginning in 2018, return the estate, generation-skipping transfer (GST), and gift tax exemption and rates to 2009 levels. Thus, 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.
- Require that the basis of property in the hands of the recipient could be no greater than the value of that property as determined for estate or gift tax purposes (subject to subsequent adjustments). A reporting requirement would be imposed on executors and donors to provide the necessary valuation and basis information to both the recipient and IRS. These rules would apply for transfers on or after the enactment date.
- Require a GRAT to have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. Also, the remainder interest would have to have a value greater than zero at the time the interest is created and any decrease in the annuity during the GRAT term would be prohibited. These rules would apply to trusts created after the enactment date.
- Limit the duration of GST tax exemption by, on the 90th anniversary of the creation of a trust, providing that the GST exclusion allocated to the trust would terminate. This rule would apply to trusts created after the enactment date, and to the portion of a preexisting trust attributable to additions to such a trust made after that date.
- Coordinate income and transfer tax rules applicable to grantor trusts.

- Extend an estate tax lien under Code Sec. 6324(a)(1) to apply throughout the Code Sec. 6166 deferral period, effective for estates of decedents dying on or after the effective date and for estates of decedents dying before the enactment date as to which the current law Code Sec. 6324(a)(1) lien period had not expired on the effective date.
- Clarify that the exclusion from the definition of a GST under Code Sec. 2611(b)(1) applies only to a payment by a donor directly to the provider of medical care or to the school in payment of tuition and not to trust distributions, even if for those same purposes. The proposal would apply to trusts created after the introduction of the bill proposing this change, and to transfers after that date made to pre-existing trusts.

Miscellaneous Tax Proposals

Other tax-related proposals in the budget included to:

- Increase IRS funding to nearly $12.9 billion, up approximately $1 billion from the 2012 enacted level. The budget notes that IRS investment pays for itself "several times over" given the revenue return from strong tax enforcement.
- Implement the tax provisions of the Patient Protection and Affordable Care Act (PPACA) scheduled to become effective in 2014, and respond effectively to public inquiries about PPACA's new benefits and standards.
- Reinstate and make permanent the 0.2% surtax, effective for wages paid on or after Jan. 1, 2014.
- Put in place the President's new America Fast Forward (AFF) Bonds program aimed at attracting new sources of capital for infrastructure investment. As part of the program, the budget proposes changes to the Foreign Investment in Real Property Tax Act (FIRPTA) to enhance "the attractiveness of investment in U.S. infrastructure and real estate to a broader universe of private investors."
- Mandate the streamlined electing large partnership (ELP) audit and adjustment procedures, but not the simplified reporting, for any partnership that has 1,000 or more partners at any time during the taxable year.
- Reduce the tax gap by investing in and modernizing tax administration to "prevent evasion and cheating." This includes expanding information reporting, requiring greater electronic filing of returns, and requiring more forms to be filed electronically. Additionally, the budget would establish an assessable penalty for failure to comply with electronic filing requirements.
- Increase whistleblower protections by, among other things, amending Code Sec. 7623 to explicitly protect whistleblowers from retaliatory actions, consistent with the protections currently available to whistleblowers under the False Claims Act.
- Introduce debt collection reforms to significantly increase Federal collections from individuals and businesses that haven't paid their taxes or repaid government loans.

- Index all fixed-amount penalties to inflation and round the indexed amount to the next hundred dollars.
- Provide a year of free, public preschool education for 4-year-old children that would be paid for by imposing a new cigarette tax.

Switch to Chained CPI

Beginning in 2015, the President's budget would change the measure of inflation used by the federal government for most programs (and for the Internal Revenue Code) from the standard Consumer Price Index (CPI) to the alternative chained CPI. In general, chained CPI grows at a slower pace by fully accounting for a consumer's ability to substitute between goods in response to changes in relative prices and also adjusts for small sample bias. According to the budget, most economists agree that the chained CPI provides a more accurate measure of the average change in the cost of living than the standard CPI.