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President Obama Releases 2016 Federal Budget Proposal

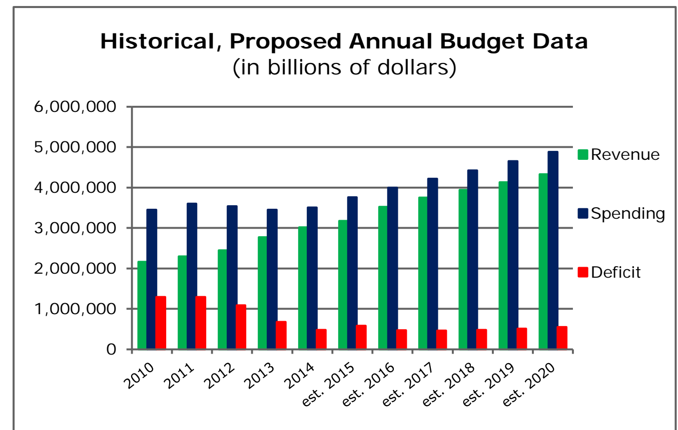
2016 proposal consistent with prior budgets, but enactment is uncertain

On the heels of his first State of the Union address to the nation after the mid-term elections, President Obama released his fiscal year 2016 budget proposal. This proposal contains many similarities to previous years, with a few new items that will affect retirement and estate planning strategies. And like prior years, its revenue proposals – in their entirety – have very little chance of becoming law. That's especially true this year as Republicans now control both houses of Congress, and those Republicans immediately denounced virtually the entire package. However, both parties seem focused on passing some type of tax reform this year, and in order to do that Republicans will likely have to concede on at least some of the President's wishes. Which of those may survive remains to be seen, but it's now up to the Republicans in Congress to respond with a proposal of their own.

The President's Budget – By the Numbers

The President's budget signaled the end of sequestration, the program that created automatic budget cuts beginning in 2013, and instead includes an increase of more than 7% in total spending for the next fiscal year.

- The 2015 budget forecasts tax revenue of almost $3.2 trillion, up more than $150 billion from 2014. Spending is budgeted at over $3.7 trillion, an increase of about $250 billion from 2014.
- As a result, there is a projected deficit for 2015 of approximately $583 billion, a 20% increase over the 2014 deficit.
- For 2016, the revenue and spending would be about $3.5 trillion and $4.0 trillion, respectively, leaving a deficit of $474 billion, more than an 11% decrease from the baseline deficit of $535 billion. The baseline amount is the projected deficit before considering the President's proposals.
- Over the 10-year budget cycle of 2016-2025, the cumulative deficit is projected to be $5.674 trillion. This is a reduction of more than $2 trillion from baseline number. At no point during the 10-year cycle is the budget forecasted to balance.
- Combined with other lending, the gross federal debt would rise from $17.8 trillion at the end of 2014 to $26.3 trillion at the end of 2025.



The following are some of the key tax and related provisions included in the President's budget.

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Significant Changes to Capital Gain Rules, including Increased Top Rate

The President has used this budget proposal to suggest substantial changes to the tax treatment of capital gains – including those realized during lifetime as well as those gains transferred to others as gifts during life or bequests after death.

To begin with, the President is proposing to increase the top tax rate on long-term capital gains and qualified dividends to 24.2%, up from today's top rate of 20%. This rate would only apply to those taxpayers whose income is in the top tax bracket (for 2015, married couples with taxable income over $464,850 and singles over $413,200). The 3.8% Medicare tax on investment income would continue to apply as under current law, bringing the combined top tax rate on capital gains and dividends to 28%. This new rate would apply to gains realized and dividends received after 2015.

In addition, this budget proposes dramatic changes to the treatment of gifts and bequests. Under today's law, when appreciated assets are transferred to another individual, the original owner's cost basis carries over to the recipient. When those same assets are transferred upon the death of the owner, the cost basis is "stepped up" to the asset's fair market value, thereby eliminating the gain. Under this proposal, both gifts and bequests of appreciated property would be treated as a sale and repurchase of the property, causing the gain to recognized and be taxable to either the donor (for gifts) or recipient (for bequests).

There are a number of exceptions that would apply to this new gain recognition rule:

- Gifts or bequests to a spouse would be exempt from this rule. However, the original owner's cost basis would carry over to the recipient, thereby simply deferring the gain on spousal transfers until the second death. Transfers to charity would also be exempt from gain recognition.
- The transfer of any personal property, such as household items or other possessions, would be exempt from this tax. However, the transfer of appreciated collectibles would be subject to the tax.
- A decedent could exclude the first $100,000 of gain realized upon the bequest of appreciated assets (no such exclusion would apply to gifts during lifetime). This exclusion would be adjusted for inflation. An additional exemption of $250,000 in gain on the transfer of a principal residence would also be available. Any unused portion of either of these exemptions could be transferred to a surviving spouse, using rules similar to the estate tax portability rules already in place.
- The proposal doesn't address the treatment of assets that have fallen in value, but presumably the current step-down rules would continue to apply.
- Capital losses and loss carry forwards would be fully deductible, even against ordinary income, on the final income tax return of the decedent. Under current law, those losses can generally only offset capital gains realized in the year of death and can't pass to a beneficiary, which means those losses often become worthless. This provision would encourage the recognition of losses prior to an individual's death so they could be used to offset other income.

These changes would all apply to gifts made or deaths occurring after 2015. For more provisions related to the transfer of assets, see the section titled "Additional Changes to the Gift & Estate Tax".

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Modified Tax Benefits for Education Expenses

Leading up to the release of the full budget proposal, the President's plan to greatly reduce the tax benefits of saving for education in 529 accounts was leaked. Significant backlash led the administration to indicate that proposal wouldn't be part of the final budget (although it remained in the budget documents that were released), but several other education-related changes remained.

- Although the 529 proposal was expected to be pulled from the budget, a similar proposal to ban further contributions to Coverdell Education Savings Accounts will likely remain. Distributions from existing accounts would remain tax-free. Coverdell ESAs are currently the only vehicle for tax benefits related to K-12 expenses.
- The American Opportunity Tax Credit (AOTC), which was originally enacted in 2009 and has been periodically extended since then, would be made a permanent replacement for the Hope Credit. The AOTC allows a tax credit of up to $2,500 for tuition and related expenses. The credit would be expanded to cover expenses for five years, rather than the current four, and a reduced credit would be available for undergraduate students attending less than half-time.
- The deduction for student loan interest would be eliminated. Student loans that are forgiven under an Income Driven Repayment program would be excluded from income.

Reduce the Maximum Tax Benefit of Various Items

The President has again proposed a cap of 28% on the benefit of various tax deductions and preferences to take effect after 2015. To illustrate this, a taxpayer in today's top tax bracket would pay 39.6% tax on every additional $10,000 of income, or an additional tax of $3,960. However, under this proposal an additional $10,000 of itemized deductions for that same taxpayer would only provide a $2,800 tax benefit, a difference of $1,160. Taxpayers in the 28% bracket or lower would not be impacted by this proposal. In addition to itemized deductions, this proposal would also apply to the following items (among others):

- Interest earned on tax-exempt state and local bonds
- Contributions to defined contribution retirement plans and IRAs
- Employer-sponsored health insurance, whether paid for by the employer or pre-tax by the employee
- Health insurance costs of self-employed individuals
- Contributions to health savings accounts and Archer MSAs
- Interest on student loans

Example: A taxpayer in the 39.6% tax bracket who earns interest on a municipal bond would pay a tax of 11.6% on that income (39.6% less 28%) in 2016.

Additional Changes to the Income Tax

The President's budget also includes several other income tax provisions, many of which were included in prior budget proposals. Unless otherwise indicated, all these items would be effective for income or expenses after 2015.

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- A new second-earned credit would available for two-earner couples filing a joint return. The credit would be equal to 5% of the first $10,000 of income for the lower-earning spouse. The maximum credit of $500 would begin phasing-out for couples with Adjusted Gross Income (AGI) over $120,000, and would be fully eliminated once AGI reached $210,000.
- One of the President's most often proposed items is to change the tax treatment of "carried interest" from capital gain to ordinary income, and it appears again in this budget. This income would also be subject to the self-employment tax.
- Accrued market discount on a bond would have to be reported as income in the year of accrual, rather than allowing this to be optional as it is today.
- The complex rules around the limits on charitable gift deductions would be simplified. Gifts of cash to public charities would still be subject to a limit of 50% of AGI, but all other gifts would be subject to a single 30% limit, irrespective of the type of gift or recipient. In addition, the carry forward period for excess contributions would be extended from five years to 15 years.
- The deduction for mileage driven for charitable purposes would be increased to 23 cents per mile, from the current 14 cents, to match the deduction for medical and moving-related mileage.
- When selling shares of stock today, investors can choose which tax lot is being sold in order to manage the gain or loss being recognized. This budget again proposes to require the use of average cost basis for all identical shares of stock owned, even those owned in different accounts or at different locations, thereby limiting the flexibility available to taxpayers. The proposal would only apply to taxable accounts, as cost basis is immaterial in tax-preferred accounts, and would only apply to stock that is considered long-term.
- The 100% exclusion on the sale of qualified small business stock held at least five years would be permanently extended, and the AMT add-back for the amount of excluded gain would be permanently repealed. The proceeds from selling small business stock held just three years could be rolled over into a new small business within six months of the sale, thereby deferring the gain.
- The amount of gain that could be deferred using a like-kind exchange transaction would be capped at $1 million per year, and art and collectibles would no longer be eligible for like-kind exchanges.
- Provisions to support working parents would be simplified or expanded. Dependent Care Flexible Spending Accounts would be repealed and replaced with expanded child care credits. The current child care credit starts at 35% of the first $3,000 in expenses for one child ($6,000 for multiple children), and then begins phasing down once income reaches $15,000. The credit falls to 20% once income exceeds $43,000. Under this proposal, the reduced credit wouldn't begin until income reaches $120,000, and wouldn't reach the 20% level until $148,000 of income.
    - Taxpayers with children under age 5 would be able to claim a credit equal to 50% of expenses up to $6,000 for one child, $12,000 for multiple children.
- The reduced phase-out provisions in the Child Credit would be made permanent, allowing low-income families to continue claiming a credit in excess of their actual tax liability. The expansion of the Earned Income Tax Credit (EITC) for low income families would also be made permanent. Both expansions

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are currently scheduled to expire after 2017. The EITC for families without children would be effectively doubled by expanding the phase-in and phase-out ranges.

- Any qualified principle residence debt that is forgiven through the end of 2017 would be excluded from income. This exclusion had expired after 2014.

Cap on Contributions to Retirement Plans

One of the more controversial of the President's recent proposals has returned again in this budget – a proposed cap on the accrual of benefits within retirement plans. Under this proposal, once the total value of all an individual's tax-favored retirement plans (Traditional and Roth IRAs, 401(k)s, 403(b)s, etc.) is large enough to provide an annuity of $210,000 per year, no further contributions may be made to any of those accounts. The $210,000 is the same maximum benefit that is available under a qualified defined benefit plan (such as an employer pension plan) for 2015.

Each year, a calculation would be made to determine how much is necessary to purchase the maximum annuity amount over the joint life expectancy of a taxpayer and their spouse who are both age 62. When this was first proposed in 2013, it was determined that with a discount rate of 4%, an annuity of that nature would require an initial investment of approximately $3.4 million. However, if interest rates were to rise – and rates continue to be at historically low levels – that value would fall. For example, at a 6% discount rate, the initial investment would be just $2.7 million, and at 8% it would be $2.3 million.[1]

Once a taxpayer's cumulative retirement plan balances would reach that level, the ban on further contributions would apply. The accounts may still continue to grow as a result of investment performance, but future contributions will be treated as excess deferrals, potentially subject to a penalty. This proposal would apply beginning in 2016.

Changes to Distributions from Retirement Plans

One of the common themes of this budget proposal is limiting the transfer of wealth over extended periods, such as the proposal regarding gifts and bequests triggering a capital gain and the cap on retirement plan balances. Another proposal along these lines is a limitation on what are commonly referred to as "stretch" techniques for inherited retirement accounts.

Rather than allowing those who inherit retirement plan accounts to take distributions from the account over their remaining life expectancy, this proposal would require most beneficiaries to liquidate those accounts by the end of the year containing the 5th anniversary of the owner's death. This proposal would not apply to any beneficiary who is a spouse of the deceased, disabled, chronically ill or who is no more than ten years younger than the original account owner. It would also not apply to beneficiaries who are minors, although they would have to deplete the account within 5 years after reaching the age of majority. This proposal would apply to retirement plans or IRAs owned by anyone who dies after 2015.

[1] Employee Benefit Research Institute, "The Impact of a Retirement Savings Account Cap", August 2013, www.ebri.org

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Three new retirement-related proposals made their first appearance in this budget. The first would be another attempt to limit the long-term transfer of wealth by subjecting Roth IRAs to the same Required Minimum Distribution rules that Traditional IRAs (as well as Roth 401(k)s and similar accounts) must follow. Today, dollars in a Roth IRA can go untouched for many years after retirement, as RMDs from those accounts only apply to non-spouse beneficiaries after the death of the Roth owner. In addition, contributions to a Roth IRA would be banned once the owner reaches age 70½, just like with Traditional IRAs.

Secondly, this proposal eliminates the Net Unrealized Appreciation technique. This NUA rule is used to reduce the tax impact of withdrawing employer stock from a qualified retirement plan, such as a 401(k) or ESOP. This repeal would only apply to taxpayers that have not yet turned age 50 by the end of 2015.

Lastly, the President is proposing a change that would effectively eliminate a technique that has come to be known as the "back door Roth IRA". This technique is a way for taxpayers whose AGI is too large to contribute directly to a Roth to instead contribute to a Traditional IRA on an after-tax basis and then convert those dollars into a Roth IRA with no tax cost – essentially the same as contributing directly to the Roth. Under this proposal, IRA owners can only do a Roth conversion of the amount in an IRA that would be taxable under a normal distribution. In other words, after-tax dollars in an IRA would no longer be eligible for a Roth conversion.

Other proposals that would affect retirement planning returned in this year's budget, including:

- Exempting individuals from the RMD rules if the aggregate value of that individual's IRAs and retirement plan balances does not exceed $100,000 (adjusted for inflation). The RMD rules would be ratably phased in for aggregate plan balances between $100,000 and $110,000, and would be effective for those turning 70½ on or after December 31, 2015.
- Non-spouse beneficiaries of an IRA or employer retirement plan are currently only allowed to roll those assets into an inherited IRA via a trustee-to-trustee transfer. This proposal would allow those beneficiaries to also use the 60-day rollover provision, which currently is only available to spousal beneficiaries, for distributions made after 2015.

Additional Changes to the Gift & Estate Tax

Beyond the changes to the step-up in basis rules, the President has again proposed rolling back the changes to the estate tax he signed into law just a few years ago. That would mean a new permanent reduction in the estate tax exemption from the current $5.43 million to $3.5 million, and an increase in the top tax rate from 40% to 45%. The gift tax exemption would be decoupled from the estate exemption and reduced to $1 million, and neither exemption would be subject to inflation adjustments. The portability provision would remain in place, however.

This budget contains several other proposed changes to the estate tax system:

- A new category of gifts would be created for those gifts that, because of restrictions placed on them by the donor, cannot be immediately liquidated by the donee. The idea of a "present interest" in a gift,

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often given through things like Crummey Notices, would go away. Instead, donors would be allowed to make up to $50,000 in total gifts each year in this category. This is an aggregate limit, meaning that even if individual gifts in this category do not exceed the annual gift tax exclusion ($14,000 today), total gifts with restricted access over $50,000 would be considered taxable.

- Grantor Retained Annuity Trusts (GRATs) would be subject to a minimum term of 10 years, and a maximum term of the life expectancy of the annuitant plus 10 years. In addition, the remainder interest at the time the trust is created must have a minimum value equal to the greater 25% of the value contributed to the trust or $500,000. This change would only apply to GRATs created after the enactment of this law.
- The cost basis of assets received by an heir would be required to equal the market value used for estate tax purposes for the decedent. It would also require the cost basis for the recipient of gifts to equal that for the donor. This rule is viewed as an attempt to reduce the impact of discounting of assets.
- Health and Education Exclusion Trusts (HEETs) would no longer be exempt from the Generation Skipping Transfer Tax. This would apply to HEETs created after a bill with this proposal is introduced in Congress, or to transfers to already existing HEETs.

Implement the Buffet Rule by Creating a "Fair Share Tax"

Another returning item in this budget is the "Fair Share Tax" (FST), meant to eliminate cases where high-income taxpayers pay tax at an effective rate lower than taxpayers with more modest income. The tentative FST would be a tax equal to 30% of taxpayer's AGI over $1 million, less a 28% credit for itemized charitable deductions that exceed the overall limit on itemized deductions. The net of these two amounts is then compared to the total regular income tax (including AMT, the 3.8% Medicare tax on investment income and employee-paid payroll taxes, but less certain credits). The amount of actual FST paid would then be phased-in as AGI rises from $1 million to $2 million.

Example: A married couple has AGI of $1.5 million and charitable contributions of $100,000, and their total regular, AMT and payroll taxes (before the FST) are $325,000. The FST is calculated as follows:

- The Tentative FST is 30% of AGI, or $450,000.
- At that AGI level, the phase-out of itemized deductions would be approximately $36,000. The charitable contribution credit would then be 28% of $64,000 ($100,000 less the $36,000 phase-out), for a net credit of about $18,000.
- The net of the tentative FST and the charitable credit is then $432,000.
- The FST owed would be $432,000 less the $325,000 in other taxes they would have paid, for a net of $107,000.
- Because their AGI is $1.5 million (less than the $2 million level where they would pay the full FST), the $107,000 is phased-in on a pro rata basis, resulting in an additional tax of $53,500.

This tax would take effect beginning in 2016, and the AGI level for the phase-out would be indexed for inflation after that year.

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Business Tax Changes

The Administration proposes adding, changing or extending a variety of provisions impacting corporate taxpayers. These changes are intended to reform the U.S. international tax system, eliminate tax preferences for oil and gas companies and improve overall tax compliance by businesses. Highlights of the corporate tax changes include:

- Businesses would be able to deduct up to $500,000 of capital expenses under Section 179 for 2015. For 2016, the deduction would be increased to $1 million, with inflation adjustments in subsequent years.
- The R&E credit allows businesses to claim a tax credit equal to 20% of qualified research expenses. This credit expired after 2014, but would be permanently extended – and expanded – in this proposal.
- The last-in, first-out (LIFO) method of inventory accounting would no longer be allowed in tax years beginning after December 31, 2015. Companies will be required to recognize taxable income related to revaluing its inventory, but can spread that income out over ten tax years.
- The budget again proposes eliminating a wide variety of tax preferences and credits currently available to the fossil fuel industry.

Miscellaneous Budget Proposals

Several other changes that affect information reporting, tax compliance and other areas were also part of the President' budget proposal. Unless otherwise indicated, all proposals take affect after 2015.

- The deadline for calendar-year partnerships to file their tax returns – and therefore issue K-1s to their partners – would be moved up to March 15 from April 15 in order to give individual taxpayers more time to complete their own tax returns. S Corporations are already subject to the March 15 deadline, and that would not change. Other corporations would have their deadline extended from March 15 to April 15.
- The Treasury Department and the IRS have in the past tried to claim regulatory authority over paid tax preparers, but the courts have decided they didn't have the power to do so. This budget would now give them the legal authority needed to regulate those preparers.
- Lenders would be required to provide additional information on Form 1098, Mortgage Interest Statement, such as the balance of the loan, the address of the property, whether the loan was a refinance, etc. This information will be used by the IRS to improve compliance with the interest deduction rules.
- Repeated willful failure to file a tax return would be considered a felony, with a fine of up $250,000 and/or up to five years in prison (up from $25,000 and/or one year currently). This applies to anyone failing to file a return in three out of five years and whose total tax liability in those years was over $50,000.
- Employers would be required to use an "identifying number" other than an employee's Social Security Number on W-2s they issue. This would be effective upon enactment of the law.
- Tax-related identity theft would be subject to longer prison sentences, as well as a new $5,000 civil penalty for each fraudulent tax return filed, with no maximum penalty. This would be effective upon enactment of the law.

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