



“Obama Budget Checkpoint”

The below article was contributed by Thomson/Reuters IRA in their February 16, 2012 Volume 58, No. 7 Article entitled “President’s FY 2012 budget proposals carry numerous tax changes.”

*Obama’s fiscal year 2013 budget potential will trim the deficit by Four Trillion (4,000,000,000,000.00) Dollars through spending cuts and tax increases. President Obama unveiled his fiscal year 2013 budget on February 13, 2012 amidst the cloud of uncertainty relating to Bush era tax cuts and more immediately the fate of the payroll tax cuts. President Obama’s fiscal year 2013 budget proposals incorporate initiatives from his “Blueprint for America” as described in his 2012 State of the Union address. As in the past, some of the President’s proposals were immediately rejected by the GOP, but others could move along quite quickly. The expected extension of the Employee Side Payroll Tax Cut could serve as a vehicle to move some of the proposals, such as an extension to the 100% bonus depreciation. **What is striking in the summary outlining the budget proposal below is the effect directly on individuals and businesses.** The most significant issue that effect individuals relates to the individual income tax rates being reinstated at the 36% and 36.9% tax brackets for high income tax payers who file, the personal exemption phase out/limitation of itemized deductions for certain taxpayers earning more than \$200,000 a year for individuals and for tax payers joint returns with incomes over \$250,000, and, the estate tax modifications which return gift and estate tax exemption and rates to 2009 levels (\$1 million) gift tax exemption; \$3.5 million estate tax exemption).*

On February 13, the President released his federal budget proposals for fiscal year 2013, and, on the same day, the Treasury released its “General Explanations of the Administration’s Fiscal Year 2013 Revenue Proposals” (the so-called “Green Book”). The revenue proposals include over 130

large and small proposed tax changes for businesses and individuals, including new incentives to “insource” jobs, higher taxes for upper-income taxpayers, and the extension of key tax breaks.

Business Tax Proposals

The budget's proposals for business include the following.

- The payroll tax cut currently in place for January and February of this year would be extended for the rest of 2012.
- Qualified employers would be provided 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 2012 eligible wages (OASDI wages) over the prior year (2011). The maximum amount of the increase in eligible wages would be \$5 million per employer, for a maximum credit of \$500,000, to focus the benefit on small businesses. For employers with no OASDI wages in 2011, eligible wages for 2011 would be 80% of their OASDI wage base for 2012. The credit would generally be considered a general business credit. A similar credit would be provided for qualified tax-exempt employers. The credit would be effective for wages paid during the one-year period beginning on Jan. 1, 2012.
- Employers currently pay FUTA tax at a rate of 6.0% (beginning July 1, 2011) on the first \$7,000 of covered wages paid annually to each employee. The rate for the first half of 2011 was 6.2%, including the 6% permanent tax rate and the 0.2% temporary surtax that expired on June 30, 2011. The net federal unemployment insurance tax on employers would permanently revert to 6.2%, effective for wages paid with respect to employment on or after Jan. 1, 2013. Also, under current law, 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, short-term relief would be provided, for example, the FUTA credit reduction for employers in borrowing States would be suspended in 2012 and 2013. Other changes would be made. For example, the FUTA wage base would be raised in 2015 to \$15,000 per worker.
- The 100% bonus first-year depreciation deduction that generally applies only for assets placed in service before 2012, would be extended through 2012.

- Use of the last-in, first-out (LIFO) accounting method would be repealed, 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.
- An additional \$5 billion of credits for investments in eligible property used in a qualifying advanced energy manufacturing project. Taxpayers would be able to apply for a credit with respect to part or all of their qualified investment. Applications for the additional credits would be made during the two-year period beginning on the date on which the additional authorization is enacted.
- Replace the existing deduction for energy efficient commercial building property with a tax credit equal to the cost of property that is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting, heating, cooling, ventilation, and hot water systems of the building by 20% or more in comparison to a reference building which meets certain minimum requirements. The tax credit would be available for property placed in service during calendar year 2013.
- Effective for bonds issued after the enactment date, make the Build America Bonds program permanent at a Federal subsidy level equal to 30% through 2013 and 28% of the coupon interest on the bonds thereafter. The 28% Federal subsidy level would be intended to be approximately revenue neutral relative to the estimated future Federal tax expenditure for tax-exempt bonds. The eligible uses for Build America Bonds also would be expanded.
- Effective after 2013, require employers in business for at least two years that have more than ten employees to offer an automatic IRA option to employees, under which regular contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsored a qualified retirement plan, SEP, or SIMPLE for its employees, it would not be required to provide an automatic IRA option for its employees. Additionally, the non-

refundable “start-up costs” tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE 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 retirement plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This expanded “start-up costs” credit for small employers, like the current “start-up costs” credit, would not apply to automatic or other payroll deduction IRAs.

- For qualified small business stock (QSBS) acquired after Dec. 31, 2011, 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, 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, would be permanently doubled 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, 2011, liberalize the tax credit available to small employers providing health insurance to employees. For example, the group of employers who are eligible for the credit would be expanded to include employers with up to 50 full-time equivalent employees and the phase-out would begin at 20 full-time equivalent employees.
- Require corporate business jets that carry passengers to be depreciated over seven years instead of five, effective for property placed in service after Dec. 31, 2012.
- Eliminate these tax preferences for oil and gas companies, generally effective after Dec. 31, 2012: investment tax credit for enhanced oil recovery projects, production credit for oil and gas from marginal wells, intangible drilling cost deduction, the deduction for tertiary injectants used as part of a tertiary recovery method, the exception to passive loss limits for

working interests in oil and natural gas properties, percentage depletion, and two-year amortization of independent producers' geological and geophysical expenditures (amortization period would be increased to seven years).

- Eliminate tax preferences for coal activities beginning in 2013 (expensing of exploration and development costs, percentage depletion for hard mineral fossil fuels, capital gains treatment for royalties, and the **Code Sec. 199** deduction).
- Tax certain “carried interest” as ordinary income, instead of at the 15% 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 section 530 of the '78 Revenue Act. Penalties would be waived for service recipients with only a small number of workers, if they had consistently filed all required information returns reporting all payments to all misclassified workers and agreed to prospective reclassification of misclassified workers. This proposal would apply on enactment, but the prospective reclassification for those covered currently by section 530 of the '78 Revenue Act would not be effective for at least one year after the enactment date.

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:

... Effective for expenses paid or incurred after the date of enactment, 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.

... Effective for expenses paid or incurred after the date of enactment, deductions for expenses paid or incurred in connection with outsourcing a U.S. trade or business would be disallowed. 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.

... Creation of a new allocated 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, 2012 through 2014.

... For tax years beginning after Dec. 31, 2012, limit the extent to which the **Code Sec. 199** domestic production deduction is allowed with respect to nonmanufacturing activities by excluding from the definition of domestic production gross receipts (DPGR) any gross receipts derived from sources such as the production of oil and gas, the production of coal and other hard mineral fossil fuels, and certain other nonmanufacturing activities. Additional revenue obtained from this retargeting would be used to increase the general deduction percentage and to fund an increase of the deduction rate for activities involving the manufacture of certain advanced technology property to approximately 18%.

... Retroactively effective after Dec. 31, 2011, make the research credit permanent and increase the rate of the alternative simplified research credit from 14% to 17%.

International Tax System

Following are highlights of the President's proposals for reforming the U.S. international tax system:

- (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 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 parent transfers an intangible to a controlled foreign corporation (CFC) in circumstances that demonstrate excessive income shifting from the U.S., then an amount equal to the excessive return would be treated as subpart F income.
- (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) Amend the rules that limit the deductibility of interest paid to related persons subject to low or no U.S. tax on that interest to prevent inverted companies from using foreign-related party and certain guaranteed debt to inappropriately reduce the U.S. tax on income earned from their U.S. operations.
- (6) Disallow the deduction for non-taxed reinsurance premiums paid to affiliates.
- (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.

Tax Changes for Individuals

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

- ... For tax years beginning after Dec. 31, 2012, reinstatement of upper-income taxpayers' reduction of itemized deductions and phaseout of personal exemptions.

... The expiration of the 2001 and 2003 (EGTRRA and JGTRRA) tax cuts for those with household income over \$250,000 a year for joint filers (\$200,000 for single taxpayers), effective after 2012.

... For dividends received after Dec. 31, 2012, the current reduced tax rates on qualified dividends would expire for income that would be taxable in the 36% or 39.6% brackets. In other words, qualified dividends for upper income taxpayers would be taxed as ordinary income.

... For long-term capital gains realized after Dec. 31, 2012, the current reduced tax rates on long-term capital gains would expire for capital gain income that, in the absence of any preferential treatment of long-term capital gains, would be taxable in the 36% or 39.6% brackets. Thus, the maximum long-term capital gains tax rate for upper-income taxpayers would be 20%.

... For tax years beginning after Dec. 31, 2012, the tax value of specified deductions or exclusions from AGI and all itemized deductions would be limited to 28% of the specified exclusions and deductions that would otherwise reduce taxable income in the 36% or 39.6% tax brackets. A similar limit also would apply under the alternative minimum tax. The limit would apply to tax-exempt state and local bond interest, employer-sponsored health insurance paid for by employers or with before-tax employee dollars, 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 and Archer MSAs, interest on education loans, and certain higher education expenses. The change would apply to itemized deductions after they have been reduced by the proposed statutory limit on certain itemized deductions for higher income taxpayers.

... The budget proposal would make permanent 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, 2012, the expansion of the EITC for workers with three or more qualifying children would be made permanent. Specifically, the phase-

in rate of the EITC for workers with three or more qualifying children would be maintained at 45%, resulting in a higher maximum credit amount and a longer phase-out range.

... For tax years beginning after Dec. 31, 2012, the AGI level at which the child and dependent care credit begins to phase down would permanently increase from \$15,000 to \$75,000. The percentage of expenses for which a credit may be taken would decrease at a rate of 1 percentage point for every \$2,000 (or part thereof) of AGI over \$75,000 until the percentage reached 20% (at incomes above \$103,000).

... The exclusion for income from the discharge of qualified principal residence indebtedness (QRPI) would be extended to amounts that are discharged before Jan. 1, 2015, and to amounts that are discharged pursuant to an agreement entered before that date.

Estate and Gift Tax Proposals

Restoration of transfer tax to 2009 levels. The estate, generation-skipping transfer (GST), and gift tax parameters as they applied during 2009 would be made permanent. 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. These changes would apply for estates of decedents dying, and for transfers made, after Dec. 31, 2012.

Portable estate tax exclusion made permanent. The provision allowing a surviving spouse to use the deceased spouse's unused estate tax exclusion, which expires for decedents dying after Dec. 31, 2012, would be made permanent.

Basis consistency and reporting requirement for donated and inherited property. 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.

Toughened rules for valuation discounts. Certain additional restrictions ("disregarded restrictions") would be ignored under **Code Sec. 2704** in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be

removed by the transferor and/or the transferor's family. The transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regs. These rules would apply to transfers after the enactment date of property subject to restrictions created after Oct. 8, 1990 (the effective date of [Code Sec. 2704](#))

Minimum and maximum term for grantor retained annuity trusts (GRATs). A GRAT would be required 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.

Duration of GST tax exemption limited. On the 90th anniversary of the creation of a trust, 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.

Coordination of income and transfer tax rules applicable to grantor trusts. The current 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. New rules for grantor trusts would prevent this by: (1) including the assets of the trust in the grantors' gross estate of that grantor for estate tax purposes, (2) subjecting to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subjecting to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax purposes. These rules would apply for trusts created on or after the enactment date and with regard to any portion of a pre-enactment trust attributable to a contribution made on or after the enactment date.

Extension of estate tax lien on [Code Sec. 6166](#) deferrals. The estate tax lien under [Code Sec. 6324\(a\)\(1\)](#) would be extended 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.

Other Proposals

Many expiring provisions would be extended. The Administration proposes to extend a number of provisions that have expired or are scheduled to expire on or before Dec. 31, 2012. For example, the optional deduction for State and local general sales taxes, the deduction for qualified out-of-pocket classroom expenses, the deduction for qualified tuition and related expenses, the Subpart F “active financing” and “look-through” exceptions, and the modified recovery period for qualified leasehold, restaurant, and retail improvements, would be extended through Dec. 31, 2013.

Reducing the tax gap. The President's budget calls for increases in IRS's tax enforcement and compliance budget to enable IRS to more effectively crack down on “tax cheats and delinquents,” and thereby bring in more revenue, and implement many recent tax law changes. The plan also includes a host of measures to expand information reporting, improve compliance by businesses (e.g., require more forms to be filed electronically), and specific changes to step up collection of taxes.