HFMA Texas State Annual Conference

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

Tax and legislative update

March 26, 2017
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Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

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Agenda

► Background
► Internal Revenue Service activity
► Congressional activity
► State and local activity
► Affordable Care Act (ACA) repeal and replace
► Tax reform update
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
The ground on which hospital exemptions are based is shifting

► The distinction between taxable and tax-exempt health systems is becoming increasingly blurred.
► The “halo effect” of tax-exempt status has diminished, and reputational risk has increased because of scrutiny from legislators, media and others.
► Federal, state and local governments are actively seeking new sources of revenues and re-evaluating “tax breaks.”
The ACA has resulted in a shrinking uninsured population, which weakens a key justification for tax exemption.

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

Recent press from across the nation

- Donald Trump elected President of the United States (2016)
- New Jersey revokes property tax exemption of nonprofit hospital (2016)
- Massachusetts Attorney General reviews large public charities’ CEO compensation and calls for additional reporting and review (2013)
- Illinois Supreme Court revokes property tax exemption of nonprofit hospital system (2010)
- Treasury promulgates new 501(r) Regulations (2014)
- Internal Revenue Service (IRS) denies exemption to accountable care organization (2016)
- IRS revokes 501(c)(3) status but grants 501(c)(4) status to health maintenance organization (HMO) (2015)
- New Alabama legislation requires entities exempt from sales tax to obtain an annual certificate and provide information about transactions (2015)
- Pennsylvania Supreme Court invalidates exemption standards more lenient than the state constitution permits (2012)
- New Jersey revokes property tax exemption of nonprofit hospital (2016)
- Illinois Supreme Court revokes property tax exemption of nonprofit hospital system (2010)
IRS activity

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
First IRS report to Congress on community benefit (2015)

- Based on 2011 data
- Charity care provided based on Centers for Medicare and Medicaid (CMS) data:
  - Tax-exempt hospitals: 2.13% of total expenses
- Unreimbursed costs for services provided by means-tested programs based on CMS data:
  - Tax-exempt hospitals: 1.94% of total expenses
- Total community benefit expenses provided by tax-exempt hospitals: 9.67% of total expenses
Second IRS report to Congress on community benefit (2016)

► Based on 2012 data
► Charity care provided based on CMS data:
  ► Tax-exempt hospitals: 2.22% of total expenses
► Unreimbursed costs for services provided by means-tested government programs based on CMS data:
  ► Tax-exempt hospitals: 1.97% of total expenses
► Total community benefit expenses provided by tax-exempt hospitals: 9.84% of total expenses
IRS Tax-Exempt and Government Entities Division (TE/GE) exam selection

- TE/GE has developed a data-driven case selection model that uses approximately 190 different queries of Form 990 data.
  - The model is used to identify organizations at highest risk of non-compliance.
  - It is less focused on market segment compliance projects.
  - The model was tested during 2015 and produced a 90% change rate.
  - The model is being more widely adopted for 2016.

- Data model would look at items such as:
  - Payroll expense
  - Number of independent contractors
  - Unrelated business income (UBI) reported on Form 990 but no Form 990T filed
IRS Tax-Exempt and Government Entities Division (TE/GE) exam selection

► Shift of resources from Exempt Organizations (EOs) determinations to Exempt Organizations examinations
  ► 15 to 20 EO tax law specialists
► Less field exams, more correspondence exams
► Examinations of tax-exempt organizations are set to increase by approximately 10% in 2016
► Revocations of 501(c)(3) tax-exempt status are increasing
IRS exemption revocations due to audit are increasing after years of decline

Approximately 5,000 EO examinations completed in FY 2016

- 2,109 of these examinations involved filing, organizational or operational issues
- 1,323 involved employment tax issues
- The other primary issues were unrelated business income (611); discontinued operations modifications/revocation (195); inurement/private benefit (192); political, legislative, governance (59); and other (495)
IRS 501(r) exam activity

- Approximately 700 reviews completed in FY16, with 166 referred for field examinations
- Agents have been trained and are currently conducting examinations, typically asking for:
  - Policies and reports with documentation of approval and dates
  - Persons knowledgeable about soliciting community input for Community Health Needs Assessments (CHNAs)
  - Proof of availability of required signs and notifications
  - Amounts generally billed (AGB) workpapers
  - Records of charges to financial assistance policy (FAP)-eligible individuals
  - Copies of notices sent to patients who were subject to extraordinary collection actions
  - Contracts with collection agencies
  - Complaints the hospital has received regarding 501(r) areas
Examinations of tax-exempt organizations to focus on five strategic areas:

- **Exemption**: Issues include non-exempt purpose activity and private inurement, enforced primarily through field examination.
- **Protection of assets**: Issues include self-dealing, excess benefit transactions and loans to disqualified persons, enforced primarily through correspondence audits and field examination.
- **Tax gap**: Issues include employment tax and unrelated business income tax liability, enforced through compliance checks, correspondence audits and field examination.
- **International**: Issues include oversight on funds spent outside the US, including funds spent on potential terrorist activities, exempt organizations operating as foreign conduits, and Report of Foreign Bank and Financial Accounts (FBAR) requirements, enforced through compliance reviews, compliance checks, correspondence audits and field examination.
- **Emerging issues**: Issues include non-exempt charitable trusts and Internal Revenue Code (IRC) 501(r), enforced through compliance reviews, correspondence audits and field examination.
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

IRS TE/GE tax-exempt bonds: update

- 2007: IRS initiates “soft-contact” compliance checks
- 2008: Introduction of Schedule K
- May 2011: Advance refunding compliance checks
- June 2011: IRS releases draft 2011 Schedule K — asks about written procedures
- August 2011: Revised Voluntary Closing Agreement Program (VCAP) procedures — encourages written procedures
- October 2011: IRS discloses plan to audit nonprofits based on Schedule K filings
IRS TE/GE tax-exempt bonds: update

► Currently: approximately 65 employees in tax-exempt bonds (TEBs)
  ► Numbers are down
  ► 38 examination agents and 27 law specialists

► Focused exams
  ► Small hospitals
  ► Sports-affiliated venues
  ► Solid waste disposal bonds
  ► Advance refundings with variable yields

► Data mining from Schedule K filings for audit selection

► Internal Revenue Manual (IRM) revised but “robust” written procedures still result in favorable exam treatment (timing of VCAP is evidence of robust procedures more so than a written document)
Background: A 501(c)(3) holding entity was merged with a 501(c)(4) arranger HMO. The 501(c)(3) entity was the remaining entity. It sought to retain its 501(c)(3) status. The IRS examiner determined that the entity did not qualify for exemption under either 501(c)(3) or 501(c)(4), relying on the IHC Health Plans and Vision Service Plan cases.

- Mere arrangement of care services was said to not meet the community benefit standard or promote social welfare.

- Although the IRS denied the HMO 501(c)(3) exemption, it recognized the entity as tax-exempt under 501(c)(4) without explanation.
Accountable care organization (ACO) — IRS denial of 501(c)(3) exemption application (PLR 201615022)

► ACO formed a clinically integrated network of health care providers to further the “Triple Aim” reform goals of the ACA:
  ▶ Reducing cost of health care for individuals
  ▶ Improving patient access to care and quality of care
  ▶ Improving population health and patient experience
► IRS denied 501(c)(3) exemption because ACO negotiated agreements between payors and providers not affiliated with ACO’s health system
  ▶ IRS noted that this activity conferred an impermissible private benefit to providers not affiliated with the health system
  ▶ IRS also noted that ACO would not have qualified as a supporting organization so it would have been classified as a private foundation if exempt
► First IRS guidance regarding ACOs that do not participate in the Medicare Shared Savings Program (MSSP)
  ▶ Notice 2011-20: MSSP ACOs serving Medicare patients may qualify for exemption
Congressional activity
Congressional activity

- Senator Charles Grassley continues active oversight:
  - Began investigating Mosaic Life Care hospital in 2015 as a result of media reports on its collection practices
  - Investigation resulted in significant operational changes and forgiveness of $16.9 million in patient debt
  - Media outlets identified similar activity by Deaconess Hospital, which then reconsidered its policies
  - May 24, 2016, letter to Finance and Judiciary Committee members noting these events and promoting “vigorous oversight” to find and fix other examples of abuse
  - June 9, 2016, letter to IRS noting these events and inquiring about IRS findings of non-compliance and enforcement actions
State and local activity: Florida

- Nationwide, a trend of “decoupling” state and local tax exemptions from federal exemption
  - Governor Rick Scott’s invitation to Yale to move to Florida and escape threats of taxation
  - Governor Scott’s statements on hospital revenue and pricing
- Interest in “payments in lieu of tax” (PILOTs) is growing nationwide
  - Florida Supreme Court is considering whether they can be enforced (*AHF-Bay Fund, LLC v. City of Largo*)
- 2014 amendments to Florida sales tax exemptions allowing disqualifications based on certain violations
- Property tax assessors focus on “charitable use,” particularly if property is being used wholly or in part for non-charitable uses
  - Special focus on medical office buildings
  - County assessors vary significantly in their inclination to be aggressive
State and local activity: New Jersey

Atlantic Health System v. Morrison, New Jersey

- Judge noted both nonprofit and for-profit activities of the hospital
- Stated that the current hospital is very different from original charity intention and that current designation was a legal fiction
- Hospital and town settled; New Jersey legislature took action, which was vetoed by Governor Chris Christie
State and local activity: West Virginia

► United Healthcare Foundation and Dorothy McCormack Center
  ► Cancer treatment facility in an underserved area running at a loss
  ► State law says any for-profit rentals jeopardize property tax exemption
  ► Court ruled in favor of the hospital, but State of West Virginia is appealing
State and local activity: Pennsylvania

- General Assembly (GA) and state Supreme Court debate which body can grant exemptions
- Pennsylvania constitution says GA can grant exemptions for “purely public charities”
- Court applied this to narrow the power of the GA
- GA passed legislation to change definition of “purely public charities” but the Court struck this down; GA attempted to amend Pennsylvania constitution but looks like it will not succeed
Court said City of Pittsburgh could not try to collect payroll tax from hospital parent organization for each of its subsidiaries.

Court did not say trying to collect the tax was wrong, but that the city would have to try to collect from each subsidiary instead of the overall parent.
State and local activity: Illinois

► Was holding hospitals to rigorous five-point test
► Amended statute so that charity care needs to exceed property tax due
► Hospital and town now disputing whether that statute was constitutional and for which tax years it should apply
Affordable Care Act (ACA) repeal and replace

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
### President Trump’s priorities for 2017

<table>
<thead>
<tr>
<th>Area</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACA reform</td>
<td>Up to bat</td>
</tr>
<tr>
<td>Tax reform</td>
<td>On deck</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>In progress</td>
</tr>
<tr>
<td>Regulatory reform</td>
<td>In progress</td>
</tr>
<tr>
<td>Immigration</td>
<td>In progress</td>
</tr>
<tr>
<td>Trade</td>
<td>Early stages</td>
</tr>
</tbody>
</table>
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
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2017 congressional timeline

**February 28:** President addressed joint session of Congress

**March 15:** Federal debt limit reinstated

**April 28:** Expiration of government funding

**September 30:** Federal Aviation Administration funding, authorization expire

**January-March:** ACA repeal/replace process proceeds

**April 7-24:** House, Senate spring recess

**Late April/May:** Tax reform process may begin in House

**July 31-September 5:** Congress summer recess

**“Must-do” items for 2017**

- Government funding beyond April 28, for remainder of FY 2017 and for FY 2018
- Federal debt limit: current suspension ends March 15, 2017
- Supreme Court nomination and other Administration appointments
- Federal Aviation Administration (FAA) reauthorization
- Children’s Health Insurance Program – expires September 30, 2017
## Taxes and fees repealed based on House proposed legislation released 3/6/17 (“AHCA”)

<table>
<thead>
<tr>
<th>Individual mandate (penalty reduced to $0 retroactive to 1/1/16)</th>
<th>Employer mandate (penalty reduced to $0 retroactive to 1/1/16)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional Medicare and Medicare investment tax on high income taxpayers</td>
<td>Ban on flexible spending account over-the-counter medical reimbursements</td>
</tr>
<tr>
<td>Medical devices</td>
<td>Tanning tax</td>
</tr>
<tr>
<td>Health insurance industry</td>
<td>Deduction limit on health insurance executives’ compensation</td>
</tr>
<tr>
<td>Prescription pharmaceuticals</td>
<td>Ban on flexible spending account over-the-counter medical reimbursements</td>
</tr>
<tr>
<td>Health flexible spending account limits</td>
<td></td>
</tr>
</tbody>
</table>

### Revenue Enhancements and cost savings based on AHCA

| Reduction in Medicaid expenditures | Cadillac tax applies beginning 2025 |
## Repeal and replace

### What it might look like

<table>
<thead>
<tr>
<th>Access to coverage</th>
<th>Possible provisions based on AHCA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium tax credits/cost sharing</td>
<td>▶ PTCs to continue thru 2019&lt;br&gt;▶ New tax credit based on age and income; advanceable and refundable (in 2020)&lt;br&gt;▶ Available to those who are not eligible for employer or government coverage&lt;br&gt;▶ Expansion of health savings accounts</td>
</tr>
<tr>
<td>Insurance marketplaces</td>
<td>▶ Individual market&lt;br&gt;▶ Funding for state-run high risk pools</td>
</tr>
<tr>
<td>Medicaid coverage</td>
<td>▶ Medicaid reform capping federal liability&lt;br&gt;▶ Medicaid expansion continues thru 2019&lt;br&gt;▶ Funding based per capita</td>
</tr>
<tr>
<td>Preexisting conditions</td>
<td>▶ Premium surcharges (30%) for failure to maintain continuous coverage</td>
</tr>
<tr>
<td>Market reform provisions (e.g., Dependent coverage until age 26)</td>
<td>▶ Not addressed through reconciliation</td>
</tr>
</tbody>
</table>
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Repeal and replace
What it might look like

► Individual insurance marketplace stabilization
  ► Cut back regulations and fees
  ► Provide for age-based rating relief
  ► Narrow special enrollment periods and enhance verification
  ► Enhance access to coverage and continuous coverage requirements
  ► Permit insurance to be sold across state lines
Implications for major stakeholders

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
State decisions on Medicaid expansion

State expanded Medicaid: 31 + DC
State not pursuing Medicaid expansion: 19

*The Governor-elect of Kentucky announced plans to roll back the state’s expansion of Medicaid; however, to date no plans have been finalized.
State activity in light of potential changes to ACA

- Governors speaking out on state impact of ACA replace proposals
- Patterns beginning to emerge
  - Massachusetts
  - Vermont
  - Municipalities
- Analysis of options in light of changes in federal funding
  - State innovation grants
  - Medicaid changes
  - New compliance and reporting needs
Key elements

► Signed on January 20, 2017, “Minimizing the Economic Burden of the Patient Protection and Affordable Care Act Pending Appeal”

► Seeks the prompt repeal of the Affordable Care Act

► In the meantime:
  ► Ensure that the ACA is being efficiently implemented
  ► Take all actions consistent with law to minimize the unwarranted economic and regulatory burdens of the ACA
Recent IRS developments

- IRS Announcement dated February 15, 2017, revoking new business rule to reject Forms 1040 with blank line 61

- IRS Notice 2016-70 addresses “good faith” transition relief for 2016 reporting and extension of due date for furnishing statements

- IRS Issuing 5699 Notices requesting information from employers whose 2015 Form 1094-C was not received

- IRS FAQ’s updated to indicate that employer shared responsibility assessments for 2015 will be issued beginning in early 2017

- January 9, 2017, IRS Commissioner John Koskinen updated members of Congress on the 2016 tax filings related to Affordable Care Act provisions
Reporting responsibilities under current law

- Employers must annually compile data and provide every full-time employee with a Form 1095-C as well as provide the IRS on Form 1094-C.

- 2016 reporting deadlines for IRS transmissions are this month and 2017 reporting deadlines begin in January of 2018.

- To date, 2017 reporting obligations have not changed, so employers have generally “stayed the course” with plans that allow them to address current and relevant facets of ACA risk, compliance and reporting, and support of the 95% offer levels, including workforce analysis and audit support.

- New regulatory or legislative changes are possible.
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?

Potential implications for employers as ACA and healthcare reform process continues

► Elimination of employer mandate penalties

► **Effect on** employer reporting during repeal, replace or transition periods, including the possibility of new state requirements

► Decisions on plan design and coverage for full and **part-time** employee populations in preparation for new plan year and open enrollment periods

► New valuation, tax and reporting implications for employer if Cadillac tax or cap on the tax exclusion for health care is enacted

► Potential cutback to Medicaid eligibility increasing employee enrollment **or uninsured employees**
Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
### Trump versus House Blueprint: business

<table>
<thead>
<tr>
<th>Tax provision</th>
<th>Trump</th>
<th>House GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top corporate tax rate (now 35%)</td>
<td>15% top corporate rate AMT eliminated</td>
<td>20% top corporate rate AMT eliminated</td>
</tr>
<tr>
<td>Top pass-through rate (now 39.6%)</td>
<td>15% rate for pass-through entities that retain profits within the business</td>
<td>25% rate for the “active business income” of sole proprietorships and pass-through entities</td>
</tr>
<tr>
<td>Cost recovery</td>
<td>Elective 100% immediate expensing for manufacturers</td>
<td>100% immediate expensing for all tangible and intangible assets except land</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>Manufacturers electing to expense capital investment lose the deductibility of corporate interest expense</td>
<td>No deduction will be allowed for net interest expense</td>
</tr>
<tr>
<td>Net operating losses (NOLs)</td>
<td>(Not addressed)</td>
<td>- Carrybacks of NOLs not permitted</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Deduction allowed for NOL carryforward limited to 90% of net taxable amount for year determined w/o regard to carryforward</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- NOLs allowed to be carried forward indefinitely</td>
</tr>
<tr>
<td>Other business preferences</td>
<td>Calls for them to generally be eliminated, except for R&amp;D credit and LIFO</td>
<td>Calls for them to generally be eliminated, except for R&amp;D credit and LIFO</td>
</tr>
</tbody>
</table>
## Trump versus House Blueprint: international

<table>
<thead>
<tr>
<th>Tax provision</th>
<th>Trump</th>
<th>House GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandatory tax on previously untaxed accumulated foreign earnings regardless of whether repatriated</td>
<td>10% rate, no further details provided</td>
<td>► 8.75% rate for cash/cash equivalents,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>► 3.5% rate for other earnings (e.g. those reinvested in hard assets outside the US)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>► tax payable over 8 year period</td>
</tr>
<tr>
<td>Taxation of future foreign earnings</td>
<td>In 2015, proposed worldwide system, repeal of deferral; currently unclear</td>
<td>Territorial; 100% exemption for dividends paid from foreign subs.</td>
</tr>
<tr>
<td>Border adjustability</td>
<td>No provision, but Trump has criticized the idea: “[Y]ou don’t need that plus lower taxes and everything else. And it’s too complicated… I don’t want that. I just want it nice and simple.” Still, “It’s certainly something that’s going to be discussed,” he said. “I would say, over the next month-and-a-half, two months, we’ll be having more concrete discussions.”</td>
<td>- Destination-based system with exports exempt from tax with cost of goods sold remaining deductible. All imports non-deductible. Applies to services as well as to tangible and intangible property. - Emphasis is on a “Made in America” policy with goal of eliminating tax incentive to move operations outside the US.</td>
</tr>
</tbody>
</table>
# Trump versus House Blueprint: individual

<table>
<thead>
<tr>
<th>Tax provision</th>
<th>Trump</th>
<th>House GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top pass-through rate (now 39.6%)</td>
<td>15% rate for pass-through entities that retain profits within the business</td>
<td>25% rate for the “active business income” of sole proprietorships and pass-through entities</td>
</tr>
<tr>
<td>Individual rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)</td>
<td>12% $0 to $75,000</td>
<td>12% $0 to $75,300</td>
</tr>
<tr>
<td></td>
<td>25% $75,000 to $225,000</td>
<td>25% $75,300 to $231,450</td>
</tr>
<tr>
<td></td>
<td>33% $225,000+</td>
<td>33% $231,450+</td>
</tr>
<tr>
<td>Individual AMT</td>
<td>Repealed</td>
<td>Repealed</td>
</tr>
<tr>
<td>Capital gains and dividends</td>
<td>Current law rates:</td>
<td>50% deduction for capital gains, dividends, interest; rates of:</td>
</tr>
<tr>
<td></td>
<td>► 0%</td>
<td>► 6%</td>
</tr>
<tr>
<td></td>
<td>► 15%, and</td>
<td>► 12.5%, and</td>
</tr>
<tr>
<td></td>
<td>► 20%</td>
<td>► 16.5%</td>
</tr>
<tr>
<td>3.8% Net Investment Income Tax (NIIT)</td>
<td>Repealed</td>
<td>Repealed under health reform</td>
</tr>
<tr>
<td>Carried interest</td>
<td>Ordinary income</td>
<td>(Not addressed)</td>
</tr>
<tr>
<td>Estate tax (now 40% rate, $5.45 million exemption)</td>
<td>Repealed, capital gains held until death taxable, first $10 million tax-free</td>
<td>Repealed</td>
</tr>
<tr>
<td></td>
<td>► Contributions of appreciated assets into a private charity established by a decedent will be disallowed</td>
<td></td>
</tr>
</tbody>
</table>
### Trump versus House Blueprint: individual

<table>
<thead>
<tr>
<th>Tax provision</th>
<th>Trump</th>
<th>House GOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and local tax deduction</td>
<td>Cap itemized deductions at $100,000 for single filers and $200,000 for couples</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Charitable contribution deduction</td>
<td></td>
<td>Retained, but could be modified</td>
</tr>
<tr>
<td>Mortgage interest deduction</td>
<td></td>
<td>Retained, but could be modified</td>
</tr>
<tr>
<td>Life insurance build-up</td>
<td>Included in income for high earners</td>
<td>(Not addressed)</td>
</tr>
<tr>
<td>Standard deduction, personal exemption</td>
<td>Personal exemptions, HOH filing status eliminated; Standard deduction of:</td>
<td>Consolidate current deductions exemptions to standard deduction of:</td>
</tr>
<tr>
<td></td>
<td>► $30,000 for married filing jointly</td>
<td>► $24,000 for married filing jointly</td>
</tr>
<tr>
<td></td>
<td>► $15,000 for other individuals</td>
<td>► $18,000 for singles with a child</td>
</tr>
<tr>
<td></td>
<td></td>
<td>► $12,000 for other individuals</td>
</tr>
<tr>
<td>Dependent care expenses</td>
<td>- Deduction for care expenses, up to 4 children, elderly dependents, capped at the average cost of care for state of residence - Available to those earning $250,000 per year or less for individuals, $500,000 couples</td>
<td>(Not addressed)</td>
</tr>
<tr>
<td>Earned Income Tax Credit</td>
<td>Retained with addition of spending rebates for certain low and middle-income taxpayers</td>
<td>Retained</td>
</tr>
</tbody>
</table>
Questions?

Confronting exemption erosion — How are you protecting the foundations of your tax-exempt status?
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