



# Tax provisions in administration's FY 2017 budget proposals

Passthroughs

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## HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2017 BUDGET RELATING TO PASSTHROUGH ENTITIES

KPMG has prepared a 103-page [report](#) that summarizes and makes observations about the revenue proposals in the administration's FY 2017 budget. For ease of reference, we have compiled our summaries and observations relating to certain specific industries and topics in separate booklets. This booklet highlights revenue proposals that may be of interest to passthrough business entities. Other booklets address proposals relating to other topics.

### Background

President Obama on February 9, 2016, transmitted to Congress his fiscal year (FY) 2017 budget, containing the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2016. Although it is not expected that Congress will enact—or even vote on—the president's budget as a whole, the budget represents the administration's view of the optimum direction of spending and revenue policy.

The budget would, according to the White House, reduce the deficit by \$2.9 trillion over 10 years. More than \$900 billion of that reduction would be attributable to changes in the taxation of capital gains and the reduction of tax benefits for upper income individuals. Reduction would also be achieved through changes in the taxation of international business income (which would raise almost \$800 billion in new revenue over 10 years), and from other business tax changes (which would raise approximately \$337 billion).

The president also proposes to impose a new fee on oil that would raise almost \$320 billion over 10 years. That new revenue would be committed to investment in transportation infrastructure as part of a multi-agency initiative to build a “clean” transportation system less reliant on carbon-producing fuels.

The budget also reiterates the president's goal of cutting the corporate tax rate and making structural changes and closing loopholes. In *The President's Framework for Business Tax Reform* (February 2012), he proposed cutting the corporate rate to 28%. The budget does not, however, provide sufficient revenue to offset the cost of such a rate reduction.

### Business tax proposals

Many other tax proposals in the FY 2017 budget are familiar, having been included in previous budgets, such as:

- Reforms to the international tax system
- Limiting the ability of domestic entities to expatriate

- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Marking financial derivatives to market and treating gain as ordinary income
- Modification of the depreciation rules for corporate aircraft
- Denying a deduction for punitive damages
- Imposing a tax on the liabilities of financial institutions with assets in excess of \$50 billion

Some previous proposals have been modified significantly, such as expanding the types of property subject to a proposed change to the like-kind exchange rules.

In place of the current system of deferral of foreign earnings, the president is again proposing a minimum tax on foreign earnings above a risk-free return on equity invested in active assets. The minimum tax, imposed on a country-by-country basis, would be set at 19% less 85% of the per-country foreign effective tax rate. The new minimum tax would be imposed on a current basis, and foreign earnings could then be repatriated without further U.S. tax liability.

As part of the transition to the new system of taxation of foreign earnings, the budget would also impose a one-time 14% tax on earnings accumulated in CFCs that have not previously been subject to U.S. tax.

### **Individual (personal) tax revisions**

As in the case of businesses, many of the individual (personal) tax proposals in the budget are familiar, including measures that generally would:

- Limit the tax value of certain deductions and exclusions to 28%
- Impose a new minimum tax (the so-called “Buffett Rule”) of 30% of AGI
- Limit the total accrual of tax-advantaged retirement benefits
- Restore the estate, gift, and GST parameters to those in effect in 2009

Among the set of revisions proposed involves reforms to the taxation of capital gains for upper-income taxpayers, which would offset the cost of extension and expansion of tax preferences for middle- and lower-income taxpayers. The highest tax on capital gains would be increased from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, the Green Book\* indicates that a transfer of appreciated property would generally be treated as a sale of the property. Thus, the donor or deceased owner of an appreciated asset would be subject to capital gains tax on the excess of the asset’s fair market value on the date of the transfer over the transferor’s basis.

The budget also includes a proposal to expand the definition of net investment income to include gross income and gain from any trades or businesses of an individual that is not otherwise subject to employment taxes. The change would potentially affect limited partners and members of LLCs, as well as S corporation owners.

In response to concern that employees in employer-sponsored health plans might unfairly become subject to the Affordable Care Act's excise tax on high-cost plans because they reside in states where health care costs are higher than the national average, the president also proposes modifying the threshold for application of that tax.

### **Treasury's explanation**

The Treasury Department on February 9 released an accompanying explanation of the tax proposals of the budget—Treasury's [Green Book\\*](#) [PDF 1.85 MB]—which describes those proposals in greater detail.

\*General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals

### **User's guide**

=\$ U.S. dollar

%= percent

PATH Act = Protecting Americans from Tax Hikes Act of 2015 (enacted December 18, 2015)

Green Book = Treasury's *General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals*

## Tax Proposals Relating to Passthrough Entities

This booklet addresses the following budget proposals:

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## Modifications of partnership tax rules

### Deny publicly traded partnership (PTP) status for fossil fuel activities

Section 7704 provides that certain partnerships may be publicly traded entities while maintaining passthrough status. These entities are not subject to corporate tax.

To qualify for this treatment, 90% or more of the gross income of the partnership must be qualifying income. Qualifying income generally includes income derived from (among other sources) the exploration, development, mining or production, processing, refining, transportation (including pipelines), or marketing (other than at retail to an end user) of certain fossil fuels.

As in last year's budget proposal, the administration's FY 2017 budget proposes to repeal the exemption from corporate tax for PTPs that derive qualifying income from activities relating to fossil fuels. The proposal would be effective after December 31, 2021.

#### KPMG observation

When the PTP provisions were originally enacted, fossil fuels were included in the qualified income exception to the treatment of PTPs as C corporations because that industry had traditionally used partnership entities. The majority of PTPs treated as partnerships are energy related.

Notably, the Tax Reform Act of 2014 proposed by the former Chairman of the House Ways and Means Committee, Dave Camp, in the last congress also included narrowing the scope of the PTP rules. However, the Camp tax reform bill would have required financial services PTPs to be classified as corporations, but would have allowed fossil fuel PTPs to maintain passthrough status.

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

The administration's FY 2017 proposal includes a measure to tax carried interests in investment partnerships as ordinary income, effective for tax years ending after December 31, 2016. The proposal appears to be substantially the same as the proposal that was included in the administration's budget for the previous fiscal year. The proposal, however, reflects a different approach than that taken in former Ways and Means Chairman Camp's 2014 tax reform bill.

The Green Book generally indicates that the administration's proposal would tax as ordinary income a partner's share of income from an investment services partnership interest (ISPI) in an investment partnership; would require the partner to pay self-employment taxes on such income; and generally would treat gain recognized on the sale of such interest as

ordinary. An ISPI generally would be a carried interest in an investment partnership that is held by a person who provides services to the partnership. A partnership would be an investment partnership only if: (1) substantially all of its assets were investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to such assets); and (2) over half of the partnership's contributed capital was from partners in whose hands the interests constitute property not held in connection with a trade or business. The administration's proposal continues to provide exceptions for "invested capital," as well as anti-abuse rules applicable to certain "disqualified interests."

As was the case for the previous fiscal year's budget proposal, the Green Book continues to indicate that:

*...to ensure more consistent treatment with the sales of other types of businesses, the [a]dministration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.*

### **KPMG observation**

The proposal does not adopt a change contained in the Carried Interest Fairness Act of 2015 (H.R. 2889 and S. 1686) which, in defining the scope of an "investment partnership," would have required only that "less than 75 percent of the capital in the partnership is attributable to qualified capital interests which constitute property held in connection with the trade or business of the owner of such interest." By retaining the "over half" threshold from prior proposals, slightly fewer entities would qualify as "investment partnerships," so that interests in these excluded entities would not be subject to the carried interest proposal.

### **Repeal technical terminations of partnerships**

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

Similar to the FY 2015 and 2016 proposals, the administration's FY 2017 proposal would repeal the technical termination rule of section 708(b)(1)(B), effective for transfers after December 31, 2016.

## KPMG observation

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

## Extend partnership basis limitation rules to nondeductible expenditures

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

As was the case for the previous fiscal year's budget proposal, the administration's FY 2017 proposal would modify the statutory loss limitation rule to provide that a partner's distributive share of expenditures not deductible by the partnership (or chargeable to capital account) is allowed only to the extent of the partner's adjusted basis in the partnership interest at the end of the year.

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

*Because of a technical flaw in the statute, which was written in 1954, it appears that the limitation does not apply, for example, to charitable contributions and foreign taxes of the partnership, because those items are not deductible in computing partnership income. Because a partner's basis cannot be decreased below zero, a partner with no basis is allowed a deduction (or credit) for these items without having to make the corresponding reduction in the basis of his partnership interest that would otherwise be required.*

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

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

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

As was the case for the previous fiscal year's budget proposal, the FY 2017 proposal would extend the mandatory basis adjustment rules for transfers of partnership interests to require an adjustment with respect to the transferee partner, if such partner would be allowed a net loss in excess of \$250,000 if the partnership were to sell its assets for cash for fair market value in a fully taxable transaction immediately after the transfer. The adjustment would be required even if the partnership as a whole did not have a substantial built-in loss.

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

### **Tax gain from the sale of a partnership interest on look-through basis**

The FY 2017 proposal would characterize gain or loss from the sale or exchange of a partnership interest as income effectively connected with the conduct of a trade or business in the United States (ECI) to the extent attributable to the transferor partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code.

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

obligation by withholding on future distributions that otherwise would have gone to the transferee partner.

This proposal would be effective for sales or exchanges after December 31, 2016.

### **KPMG observation**

The proposal would codify a longstanding IRS position set out in Rev. Rul. 91-32.

## **Modification to employment tax and net investment income tax rules for passthrough entities**

The NIIT and the SECA taxes impose a 3.8% tax on certain income and gain of individuals over a threshold amount. The threshold amounts are \$200,000 (for single and head of household returns) and \$250,000 (for joint returns). Individuals with incomes over these thresholds may currently be excluded from either of these taxes, however. For example, limited partners and S corporation shareholders who materially participate in their businesses may avoid both the SECA taxes and the NIIT on certain income and gains.

The proposal has two components and would be effective for tax years beginning after December 31, 2016. The first component is to amend the definition of net investment income to include income and gain from any trade or business of an individual that is not otherwise subject to SECA taxes. In other words, if an individual has trade or business income that is not subject to SECA because of certain exclusions from SECA, that income would be treated as net investment income. The proposal would also cause gain on the sales of trade or business property to be included in the definition of net investment income. As under current law, the tax on net investment income would apply only to individuals with incomes over the thresholds. In addition, all revenue from the NIIT would be directed to the Medicare Hospital Insurance Trust Fund, just as is the revenue from the current 3.8% tax under FICA and SECA.

The second component is to treat individual owners of professional service businesses taxed as either S corporations or partnerships as subject to SECA taxes in the same way. Professional service businesses would be defined as partnerships and S corporations if substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, investment advice or management, brokerage services and lobbying.

Owners who materially participate in the trade or business would be subject to the SECA taxes on their distributive shares of S corporation or partnership income. The current exemptions from SECA (for rents, dividends, capital gains, and certain retired partner income) would continue to apply. Owners who do not materially participate in the trade or

business would be subject to SECA only on the “reasonable compensation” for their services, including guaranteed payments for services. Finally, distributions of compensation to owners of S corporations and partnerships would no longer be treated as wages subject to FICA but would be included in earnings subject to SECA taxes.

## Compliance changes

### Enhance electronic filing of returns

**Require greater electronic filing of returns:** Currently, corporations that have assets of \$10 million or more and that file at least 250 returns (including information returns) per year and partnerships with more than 100 partners are required to file electronically. Under the administration’s FY 2017 proposal, all corporations and partnerships with \$10 million or more in assets would be required to file electronically. In addition, regardless of asset size, corporations with more than 10 shareholders and partnerships with more than 10 partners would be required to file their tax returns electronically, and preparers that expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file these returns electronically.

Regulatory authority would be expanded to allow reduction of the 250-return threshold in the case of information returns such as Forms 1042-S, 1099, 1098, 1096, 5498, 8805, and 8966. Any new regulations would be required to balance the benefits of electronic filing against any burden that might be imposed on taxpayers, and implementation would take place incrementally to afford adequate time for transition to electronic filing. Taxpayers would be able to request waivers of this requirement in limited circumstances or as otherwise specified in regulations.

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

**Impose e-filing mandatory on exempt organizations:** The administration’s FY 2017 proposal would require that all Forms 8872 and Form 990 series tax and information returns be filed electronically and would require the IRS to make the electronically filed Forms 8872 and Form 990 series returns publicly available in a machine readable format in a timely manner, as provided in regulations.

The proposal generally would be effective for tax years beginning after the date of enactment. Transition relief would allow up to three additional years to begin electronic filing for smaller organizations and organizations for which electronic filing would be an undue hardship without additional transition time. In addition, the proposal would grant the IRS discretion to delay the mandate for Form 990-T filers for up to three tax years.

**Require taxpayers who prepare their returns electronically but file their returns on paper to print their returns with a scannable bar code:** The administration's FY 2017 proposal would provide the Secretary with authority to require all taxpayers who prepare their tax returns electronically but print their returns and file them on paper to print their returns with a scannable bar code to enable the IRS to convert the paper return into an electronic format.

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

**Impose a penalty on failure to comply with electronic filing requirements:** A return that is required to be e-filed but is instead filed on paper can be treated as a failure to file, but no penalty may result if the corporation is in a refund, credit, or loss position (since the penalty is based on the underpayment of tax). The administration's FY 2017 proposal would establish an assessable penalty for a failure to comply with a specific e-file requirement. The penalty would be \$25,000 for a corporation and partnerships, and \$5,000 for any tax-exempt organization or employee benefit or welfare plan, unless reasonable cause for the failure to file electronically is established.

For failure to file in any format the existing penalties would remain and the proposed penalty would not apply.

The penalty would be effective for returns required to be electronically filed after December 31, 2016. These provisions were separately included in the administration's FY 2016 budget proposals.

### **Accelerate information return filing due dates**

Many information returns, including Forms 1099, 1098, and 1096, are required to be filed with payees by January 31 and with the IRS by February 28 of the year following the year for which the information is being reported. Third-party information is used by taxpayers to assist them in preparing their income tax returns and used by the IRS to determine a taxpayer's compliance with federal tax obligations.

The administration's 2017 budget proposal would accelerate the due date for filing information returns and eliminate the extended due date for electronically filed returns. Under the proposal, information returns would be required to be filed with the IRS (or SSA, in the case of Form W-2) by January 31, except that Form 1099-B would be required to be filed with the IRS by February 15. The due dates for the payee statements would remain the same.

The proposal would be effective for returns required to be filed after December 31, 2016. This provision was included in the administration's FY 2016 budget proposals.

## **Authorize the limited sharing of business tax return information to improve the accuracy of important measures of the economy**

Current law authorizes the IRS to disclose certain federal tax information (FTI) for governmental statistical use. However, the Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI and the Bureau of Economic Analysis (BEA) is only authorized for corporate businesses.

The administration's FY 2017 proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than \$250,000 and of all partnerships. BEA contractors would not have access to FTI.

The proposal would also give officers and employees of BLS access to certain business (and tax-exempt entities) FTI. In effect, the proposal would allow officers and employees of each of BLS, BEA, and Census Bureau to access the same FTI for businesses, and would permit BLS, BEA, and Census to share such FTI amongst themselves subject to certain restrictions.

The proposal would be effective upon enactment. This provision was included in the administration's FY 2015 and 2016 revenue proposals.

## **Selected changes to individual tax rules**

### **Reform the taxation of capital income**

Under current law, capital gains are taxable only on the sale or other disposition of an appreciated asset. The long-term capital gains tax rate (which also applies to qualified dividends) is generally 15% or 20% (for taxpayers subject to the highest rate of income tax) with an additional 3.8% net investment income tax which may also be applicable on the gain. Currently, when an individual transfers assets at death, the recipient generally receives the assets with a basis equal to the fair market value of the asset on the date of death. When an individual transfers assets during life, the recipient generally receives the assets with a basis equal to the donor's basis in the assets on the date of the gift. There is no recognition of capital gain on the date of death or gift.

The administration's proposal would increase the tax rate on long-term capital gains (and qualified dividends) to 24.2%, which in conjunction with the 3.8% net investment income tax would tax long-term capital gains at 28%. The administration's proposal would also treat the transfer of appreciated property (during life or at death) as a sale of the property with any inherent gain realized and subjected to capital gains tax at that time. Tax incurred on gains deemed realized at death would be deductible for estate tax purposes. Transfers to a spouse or to a charity would not trigger the capital gains tax and would instead carry over

the basis of the donor or decedent to the recipient. In addition, the proposal would exempt any gain on tangible personal property (items like furniture, clothing and other household items) other than art and similar collectibles, exempt up to \$250,000 per person of gain on a residence, and exempt up to \$100,000 per person (indexed for inflation) of other gain. The residence and general exemptions would be portable between spouses such that couples could collectively exempt \$500,000 of gain on a residence and \$200,000 of other gain.

The exclusion under current law for capital gain on certain small business stock would also apply. The proposal makes tax due on the gain attributable to certain small family- owned and family-operated businesses only when they are actually sold or cease to be family- owned and operated. It also includes an option to pay tax on any gains not associated with liquid assets over 15 years using a fixed rate payment plan.

The proposal would be effective for long-term capital gains realized and qualified dividends received in tax years after December 31, 2016, and for gifts made and for decedents dying after December 31, 2016.

### **Implement the Buffett rule by imposing a new “fair share tax”**

Under current law, individual taxpayers may reduce their taxable income by excluding certain income such as the value of health insurance premiums paid by employers and interest on tax-exempt bonds. They can also claim certain itemized or standard deductions in computing adjusted gross income such as state and local taxes and home mortgage interest. Qualified dividends and long-term capital gains are taxed at a maximum rate of 23.8% while ordinary income, including wages, is taxed at graduated rates as high as 39.6%.

The wage base for much of the payroll tax is capped at \$118,500 in 2016, making average marginal rates for those earning over that amount lower than the 15.3% rate paid by those making at or below \$118,500 (although half this amount is the liability of the employer).

The administration’s FY 2017 proposal would impose a new minimum tax, called the “fair share tax” (FST), phasing in for taxpayers having \$1 million of AGI (\$500,000 if married filing separately). The tentative FST would equal 30% of AGI less a credit for charitable contributions. The charitable credit would equal 28% of itemized charitable contributions allowed after the limitation on itemized deductions (the “Pease limitation”). Final FST would be the excess of the tentative FST over regular income tax (including AMT and the 3.8% surtax on investment income, certain credits, and the employee portion of payroll taxes). The tax would be fully phased in at \$2 million of AGI (\$1 million if married filing separately). AGI thresholds would be indexed for inflation beginning after 2017.

The proposal would be effective for tax years beginning after December 31, 2016.

## Reduce the value of certain tax expenditures

The administration's FY 2017 proposal would limit the tax value of certain specified deductions and exclusions from AGI, and all itemized deductions. This limitation would reduce to 28% the value of these deductions and exclusions that would otherwise reduce taxable income in the 33%, 35%, or 39.6% tax brackets. A similar limitation would apply under the alternative minimum tax.

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

This proposal would apply to itemized deductions after they have been reduced by the statutory limitation on itemized deductions for higher income taxpayers. The Green Book does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 39.6% tax bracket with a \$10,000 itemized deduction or exclusion would be able to reduce their tax liability by only \$2,800 on account of the deduction or exclusion, rather than \$3,960—a tax increase of \$11.60 per \$100 of itemized deductions compared with current law.

This provision would be effective for tax years beginning after December 31, 2016.

## Contact a KPMG professional:

### **Deborah Fields**

Washington National Tax

*Partner in Charge*

Passthroughs

**T:** 202-533-4580

**E:** [dafields@kpmg.com](mailto:dafields@kpmg.com)

### **Kevin Jackson**

Federal Tax

*Partner in Charge*

**T:** 214-840-2528

**E:** [kjackson@kpmg.com](mailto:kjackson@kpmg.com)

### **John Gimigliano**

Washington National Tax

*Principal in Charge*

Federal Legislative and Regulatory Services

**T:** 202-533-4022

**E:** [jgimigliano@kpmg.com](mailto:jgimigliano@kpmg.com)

[kpmg.com/socialmedia](http://kpmg.com/socialmedia)



[kpmg.com/app](http://kpmg.com/app)

