



# Tax provisions in administration's FY 2017 budget proposals

Closely Held Businesses  
and Their Owners

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# HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2017 BUDGET OF INTEREST TO CLOSELY HELD BUSINESSES AND THEIR OWNERS

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 closely held businesses and their owners. 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*

## Proposals of Potential Interest to Closely Held Businesses

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## HIGH INCOME BUSINESS OWNERS

### **Reduce the amount of itemized deductions**

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.

Treasury's 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.

### **Increase capital gain and qualified dividend rates**

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.

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 proposal is effective for long-term capital gains realized and qualified dividends received in tax years after December 31, 2016.

## **Treat transfers of appreciated property as sales, including transfers at death**

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 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 is effective for gains on gifts made and for decedents dying after December 31, 2016.

## **Impose a new "minimum" tax on higher income taxpayers**

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.

### **Reform excise tax based on investment income of private foundations**

The administration's FY 2017 proposal would impose a single tax rate of 1.35% on tax-exempt private foundations. For private foundations that are not exempt from federal income tax, the amount of tax would equal any excess of the sum of the 1.35% excise tax on net investment income and the amount of the unrelated business income tax that would have been imposed if the foundation were tax-exempt, over the amount of income tax imposed on the foundation. The proposal would also repeal special reduced excise tax rate available to tax-exempt private foundations that maintain their historic levels of charitable distributions.

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

### **Consolidate contribution limitations for charitable deductions and extend the carryforward period for excess charitable contribution deduction amounts**

Current law generally limits a donor's charitable contribution deduction to 50% of adjusted gross income (AGI) for contributions of cash to public charities and to 30% for cash contributions to most private foundations. A donor may generally deduct up to 30% of AGI for contributions of appreciated capital gain property to public charities and up to 20% to most private foundations. A donor may deduct up to 20% of AGI for contributions of capital gain property for the use of a charitable organization. Donors generally can carry forward excess amounts for five years; however, contributions of capital gain property for the use of an organization exceeding 20% may not be carried forward.

The administration's FY 2017 proposal would simplify these rules by retaining the 50% limitation for contributions of cash to public charities and replacing the deduction limit for all other contributions with a 30% limitation, regardless of the type of property donated, the type of organization receiving the donation, and whether the contribution is to or for the use of the organization. In addition, the proposal would extend the carryforward period for contributions in excess of these limitations from five years to 15 years.

The proposal would be effective for contributions made in tax years beginning after December

31, 2016.

### **Limit Roth conversions to pre-tax dollars**

The administration's FY 2017 proposal would permit amounts held in a traditional IRA to be converted to a Roth IRA (or rolled over from a traditional IRA to a Roth IRA) only to the extent a distribution of those amounts would be includable in income if they were not rolled over. After-tax amounts (those attributable to basis) held in a traditional IRA could not be converted to Roth amounts. A similar rule would apply to amounts held in eligible retirement plans.

The proposal would apply to distributions occurring after December 31, 2016.

## **ESTATE AND GIFT**

### **Restore the estate, gift, and generation-skipping transfer (GST) tax parameters in effect in 2009**

The administration's FY 2017 proposal to make permanent the estate, GST, and gift tax parameters as they applied during 2009 is substantially similar to the provision included in the administration's FY 2016 budget and would be effective for those decedents dying, and for transfers made, after December 31, 2016.

### **Expand requirement of consistency in value for transfer and income tax purposes**

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (the Act) implemented a portion of the administration's FY 2016 proposal by amending section 1014 to provide generally that the recipient's initial basis in property as determined under section 1014 cannot exceed the final value of that property for estate tax purposes if that property's inclusion in the decedent's gross estate increases the estate's liability for federal estate tax. The administration's FY 2017 proposal would expand the property subject to the consistency requirement imposed under section 1014(f) to: (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability; and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return.

The proposal would be effective for transfers after the year of enactment.

### **KPMG observation**

When Congress needed funding for the transportation bill this summer, it used a narrower version of the provision proposed in the administration's FY 2016 proposal as a revenue source to partially pay for the Act. This proposal seeks to expand the revised law to require consistency of basis even if those assets do not increase the estate tax. Many estates file only

for portability purposes or have assets that qualify for a marital deduction and as such will owe no estate tax regardless of the reported values. This provision would expand the number of estates subject to the consistency requirement.

### **Modify transfer tax rules for grantor retained annuity trusts (GRATs) and other grantor trusts**

The administration's FY 2017 proposal to require that a GRAT have a minimum term of 10 years, a maximum term of the life expectancy of the annuitant plus 10 years, and prohibit any decrease in the annuity during the GRAT term is generally similar to the provision included in the administration's FY 2016 budget. The proposal also continues to require that the remainder interest have a value equal to the greater of 25% of the value of the assets contributed to the GRAT or \$500,000 (but not more than the value of the assets contributed to the trust) at the time the interest is created. It would also prohibit the grantor from engaging in tax-free exchanges of trust assets.

This proposal would be applied to GRATs created after the date of enactment.

The administration also proposes subjecting to estate tax as part of the grantor's gross estate, the portion of the trust attributable to property received by the trust in a sales transaction or exchange with the grantor (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction). A substantially similar provision was included in the administration's FY 2016 budget.

The proposal would apply to grantor trusts that engage in a described transaction on or after the date of enactment.

#### **KPMG observation**

The FY 2017 budget requirement of an immediate gift of at least \$500,000 would significantly increase the cost of using a GRAT to achieve estate planning benefits.

### **Limit duration of generation-skipping transfer (GST) tax exemption**

The administration's FY 2017 proposal providing that on the 90th anniversary of the creation of a trust the GST exemption allocated to the trust would terminate is substantially similar to the provision included in the administration's FY 2016 budget.

The proposal would apply to trusts created after enactment or to certain additions made to such a trust after enactment.

## **Extend the lien on estate tax deferrals when estate consists largely of interest in closely held business**

The administration's FY 2017 proposal to extend the estate tax lien under section 6324(a)(1) throughout the section 6166 deferral period, for the most part, is identical to the provision included in the administration's FY 2016 budget.

The proposal is generally applicable on the date of enactment.

## **Modify generation-skipping transfer (GST) tax treatment of Health and Education Exclusion Trusts (HEETs)**

The administration proposes clarifying that section 2611(b)(1) only applies to payments by a donor directly to the provider of the medical care or the school in payment of tuition and not to trust distributions, even if made for those same purposes. This proposal is substantially similar to the provision included in the administration's FY 2016 budget.

The proposal would apply to trusts created and transfers made after date of introduction.

## **Simplify gift tax exclusion for annual gifts**

The administration proposes to eliminate the gift tax annual exclusion's present interest requirement with respect to certain gifts. Further, the proposal would impose an annual gift tax annual exclusion limit per donor of \$50,000 (indexed for inflation after 2017) on transfers of property within a new category of transfers including transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee. These proposals are substantially similar to the proposals included in the administration's FY 2016 budget.

The proposals would be effective for gifts made after the year of enactment.

## **Expand applicability of definition of executor**

The administration proposes to empower an authorized party to act on behalf of the decedent in all matters relating to the decedent's tax liability by expressly making the Code's definition of executor applicable for all tax purposes and authorizing such executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or obligations that the decedent could have done if still living. This proposal is substantially similar to the provision included in the administration's FY 2016 budget.

The proposal would apply upon enactment, regardless of decedent's date of death.

## COMPENSATION & BENEFITS

### Make unemployment insurance surtax permanent

The Federal Unemployment Tax Act (FUTA) currently imposes a federal payroll tax on employers of 6% of the first \$7,000 paid annually to each employee. This tax funds a portion of the federal / state unemployment benefits system. States also impose an unemployment tax on employers. Employers in states that meet certain federal requirements are allowed a credit for state unemployment taxes of up to 5.4%, making the minimum net federal tax rate 0.6%.

Before July 1, 2011, the federal payroll tax had included a temporary surtax of 0.2%, which was added to the permanent FUTA tax rate. The surtax had been extended several times since its enactment in 1976, but it expired on July 1, 2011.

The administration's FY 2017 proposal would reinstate the 0.2% surtax and make it permanent.

The provision would be effective for wages paid after December 31, 2016.

### Provide for automatic enrollment in IRAs, including a small employer tax credit, increase the tax credit for small employer plan start-up costs, and provide an additional tax credit for small employer plans newly offering auto-enrollment

The administration's FY 2017 budget proposal would require employers in business for at least two years that have more than 10 employees to offer an automatic IRA option to employees. Contributions would be made to an IRA on a payroll-deduction basis. If the employer sponsors a qualified plan, it would not be required to provide an automatic IRA. However, if the employer excluded from eligibility a portion of the workforce or class of employees, the employer would be required to offer the automatic IRA option to those excluded employees.

Small employers (those with no more than 100 employees) that offer an automatic IRA arrangement could claim a temporary non-refundable credit for expenses associated with the arrangement of up to \$1,000 per year for three years. Such employers would be entitled to an additional non-refundable credit of \$25 per enrolled employee, up to a maximum of \$250, for six years. The credit would be available both to employers required to offer automatic IRAs and employers not required to do so (e.g., because they have 10 or fewer employees).

In addition, the "start-up costs" tax credit for a small employer that adopts a new qualified retirement, SEP, or SIMPLE plan would be tripled from the current maximum of \$500 per year for three years to a maximum of \$1,500 per year for three years and extended

to four years (rather than three) for any employer that adopts a new qualified plan, SEP, or SIMPLE during the three years beginning when it first offers (or first is required to offer) an automatic IRA arrangement. This credit would not apply to the automatic IRAs.

Small employers would be allowed a credit of \$500 per year for up to three years for new plans that include auto enrollment (this is in addition to the “start-up costs” credit of \$1,500 per year). Small employers would also be allowed a credit of \$500 per year for up to three years if they add auto enrollment as a feature to an existing plan.

The provision would be effective after December 31, 2017.

### **Require retirement plans to allow long-term part-time workers to participate**

The administration’s FY 2017 proposal would require section 401(k) plans to expand participation eligibility to employees who worked at least 500 hours per year, for at least three consecutive years, with the employer. Employers would receive nondiscrimination testing relief, including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements after expanding the eligibility group.

This provision would apply to plan years beginning after December 31, 2016.

### **Permit unaffiliated employers to maintain a single multiple-employer defined contribution plan**

The administration’s FY 2017 budget proposal would amend ERISA to permit unaffiliated employers to adopt a defined contribution multiple-employer plan (MEP) that would be treated as a single plan for ERISA purposes, even though the employer may not have a commonality of interests.

Unaffiliated employers eligible to participant in such a MEP would be employers that had not maintained a qualified plan within the previous three years. The provider would be required to be a regulated financial institution and agree to be a named fiduciary of the plan and the plan administrator. The provider would be required to register with the Secretary of Labor before offering the plan to employers. Each participating employer would retain fiduciary responsibility for selecting and monitoring the provider. Employers would be responsible for transmitting employee contributions to the trustee within a specified time frame.

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

#### **KPMG observation**

Similar to the auto-enrolled employer IRAs in the administration’s FY 2017 proposal, this provision is meant to encourage greater participation in retirement programs by smaller employers.

## **Rationalize Net Investment Income Tax (NIIT) and Self-Employment Contributions Act (SECA) Taxes**

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.

## **Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years**

Under the administration’s FY 2017 proposal, non-spouse beneficiaries of retirement plans and IRAs would generally be required to take distributions over no more than five

years. Exceptions would be provided for eligible beneficiaries, including any beneficiary who, as of the date of the account holder's death, is: (1) disabled; (2) a chronically ill individual; (3) an individual who is not more than 10 years younger than the participant or IRA owner; or (4) a child who has not reached the age of majority. For these beneficiaries, distributions would be allowed over the life or life expectancy of the beneficiary beginning in the year following the year of the death of the participant or owner, except that in the case of a child, the account would need to be fully distributed no later than five years after the child reaches the age of majority.

According to the Green Book, any balance remaining after the death of a beneficiary (including an eligible beneficiary excepted from the five-year rule or a spouse beneficiary) would be required to be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death.

The proposal generally would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2016. However, the requirement that any balance remaining after the death of a beneficiary be distributed by the end of the calendar year that includes the fifth anniversary of the beneficiary's death would apply to participants or IRA owners who die before January 1, 2016, if the beneficiary dies after December 31, 2016. The proposal would not apply in the case of a participant whose benefits are determined under a binding annuity contract in effect on the date of enactment.

### **Improve the excise tax on high cost employer-sponsored health coverage**

The administration's FY 2017 budget proposal would modify section 4980I—the excise tax on high cost employer-sponsored health coverage enacted in 2010 as part of the Patient Protection and Affordable Care Act. The administration's FY 2017 budget proposal would raise the threshold at which health plans are subject to the tax in states with higher health-care costs. Specifically, the proposal would modify the threshold above which the tax applies to be equal to the greater of the current law threshold (\$10,200 for individual coverage and \$27,500 for family coverage, in 2018 dollars) or the average premium for a gold-level health plan in the employees' state of residency.

In addition, the proposal would provide that the cost of coverage under a health flexible spending arrangement (FSA) for similarly situated participating employees is equal to the sum of: (1) the average salary reduction amount elected by those employees for the year; and (2) the average employer contribution for such employees for the year. Furthermore, the proposal would authorize the Secretary of the Treasury to issue guidance identifying similarly situated employees.

Finally, the proposal would require the Government Accountability Office to conduct a study of the potential effects of the excise tax on firms with unusually sick employees, in consultation with Treasury and others. The provision would be effective for tax years

beginning after December 31, 2016. However, as under current law, no employer-sponsored health plans would be subject to the tax until 2020.

### **KPMG observation**

This is a new budget proposal designed to lessen the effects of the excise tax on high cost employer-sponsored health coverage (often referred to as the “Cadillac tax”) in geographic areas where health care costs are higher than the national average. Furthermore, the proposal appears to be intended to make it easier for employers offering FSAs to calculate the excise tax owed by providing a formula for measuring the cost of coverage under an FSA.

The effective date of the tax was postponed until 2020 through legislation enacted in December 2015, and legislative proposals have been introduced by members of Congress to repeal the excise tax entirely.

## **PARTNERSHIP-RELATED ITEMS**

### **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 made 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.

### **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.

### **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.

## BUSINESS INCENTIVES

### **Expand expensing for small business**

The administration's FY 2017 proposal would increase the expensing and investment limitations under section 179. Section 179 provides that, in place of capitalization and depreciation, taxpayers may elect to deduct a limited amount of the cost of qualifying depreciable property placed in service during a tax year. For qualifying property placed in service during the 2010 through 2015 tax years, the maximum deduction amount had been \$500,000, and this level was reduced by the amount that a taxpayer's qualifying investment exceeded \$2 million. The deduction limits and thresholds for section 179 expensing were made permanent by the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).

The FY 2017 proposal would increase the expensing limitation to \$1 million for qualifying property placed in service in tax years beginning after 2016, reduced by the amount that a taxpayer's qualifying investment exceeded \$2 million (but not below zero). These limits, and the cap on sports utility vehicles, would be indexed for inflation for all tax years beginning after 2016. However, the \$35,000 increase to the expensing limit for enterprise zone businesses would not be indexed given that the FY 2017 budget proposes to replace the empowerment zone expensing provisions under section 179 with a 100% bonus depreciation provision for Promise Zones (described below).

### **Expand simplified accounting for small business and establish a uniform definition of small business for accounting methods**

Certain businesses must use an accrual method of accounting, including C corporations, a

partnership with a C corporation as a partner, and certain tax shelters. Nonetheless, “qualified personal service corporations” and certain small C corporations (generally those with \$5 million or less in average annual gross receipts for the prior three tax years, or \$1 million or less for farms) are permitted to use the cash method.

Taxpayers generally must capitalize costs incurred in the production of real or personal property and in the production or purchase of inventory. Uniform capitalization (UNICAP) rules require that these capitalized costs include both direct costs and an allocable portion of indirect costs. The UNICAP rules do not apply to a taxpayer acquiring personal property for resale if the taxpayer had \$10 million or less in average annual gross receipts for the three preceding tax years, and certain producers having \$200,000 or less of indirect costs in a tax year. Exceptions from the UNICAP rules also apply to certain specified property and expenses, including animals and certain plants produced in a farming business, and inventory items of certain qualifying small business taxpayers.

A taxpayer must account for inventories when the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer’s business, and an accrual method of accounting must be used with regard to purchases and sales whenever inventory accounting is necessary. Certain types of qualifying small taxpayers with inventories may use the cash method of accounting, and may deduct the cost of items purchased for resale and of raw materials purchased for use in producing finished goods in the year the related merchandise is sold, or, if later, in the year in which the taxpayer actually pays for the items: (1) any taxpayer (other than a tax shelter) with average annual gross receipts of \$1 million or less for the three preceding tax years, and (2) a taxpayer (other than a farming business) that would not be prohibited from using the cash method under the rules described above and that had \$10 million or less in average annual gross receipts. In general, a taxpayer in this second group qualifies only if its business activity is not classified as mining, manufacturing, wholesale or retail trade, or an information industry activity.

The administration’s FY 2017 proposal would create a uniform small business threshold at \$25 million in average annual gross receipts for the prior three tax years for allowing exceptions from certain accounting rules (with adjustments for taxpayers not having sufficient receipts history, and all entities treated as a single employer being treated as a single entity for purposes of the test). Satisfaction of the gross receipts test would allow an entity to elect one or more of the following items:

- Use of the cash method of accounting in lieu of an accrual method (regardless of whether the entity holds inventories)
- The non-application of the uniform capitalization (UNICAP) rules
- The use of an inventory method of accounting that either conforms to the taxpayer’s financial accounting method or is otherwise properly reflective of income, such as

deducting the cost of inventory items in the year the related merchandise is sold

A business the average annual gross receipts of which exceeds the threshold would not be able to make an election to use one or more simplified accounting methods for the current tax year and the following four tax years. These rules would supersede the special cash method exception rules that apply to farm corporations, but exceptions allowing the cash method by personal service corporations and by business entities that are not C corporations (other than partnerships with a C corporation partner), regardless of size, would continue. Any tax shelter would continue to be required to use an accrual accounting method. The exceptions from UNICAP that are not based on a gross receipts test would continue. The UNICAP farming exceptions would not be changed, but would be affected by the new gross receipts threshold for excepting UNICAP requirements altogether for produced property, as well as the higher threshold for requiring use of an accrual accounting method.

The provision would apply to tax years beginning after December 31, 2016, and the threshold would be indexed for inflation with respect to tax years beginning after December 31, 2017.

The Green Book indicates that a uniform definition of small business for determining applicable accounting rules and a consistent application of a gross receipts test would simplify tax administration and taxpayer compliance, that increasing the threshold amount of average annual gross receipts to \$25 million would increase the number of business entities that would be able to obtain relief from complex tax accounting rules, and that indexing the threshold for inflation ensures that the small business definition remains a current reflection of the appropriate level of gross receipts qualifying for the exceptions.

### **Increase the limitations for deductible new business expenditures and consolidate provisions for start-up and organizational expenditures**

The administration's FY 2017 proposal would increase the limitations on a permanent basis and consolidate the provisions for start-up and organizational expenditures, effective for tax years beginning after 2016.

Current law generally permits taxpayers to deduct up to \$5,000 of start-up expenditures in the tax year in which the active trade or business begins (with the amount reduced by the amount by which such expenses exceed \$50,000) and to amortize the remaining amount ratably over the 180-month period beginning with the month in which the active trade or business begins.

Similarly, current law generally permits taxpayers to deduct up to \$5,000 of organizational expenditures in the tax year in which the corporation or partnership begins business (with the amount reduced by the amount by which such expenses exceed \$50,000) and to amortize

the remaining amount ratably over the 180-month period beginning with the month in which the corporation or partnership begins business.

The administration's FY 2017 proposal would permanently allow up to \$20,000 of new business expenditures to be deducted in the tax year in which a trade or business begins (with the amount reduced by the amount by which such expenses exceed \$120,000) and the remaining amount to be amortized ratably over the 180-month period beginning with the month in which the business begins. New business expenditures would include amounts incurred in connection with: (1) investigating the creation or acquisition of an active trade or business; (2) creating an active trade or business; (3) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business; and (4) expenditures that are incident to the creation of an entity taxed as a corporation or partnership, that are chargeable to a capital account and are of a character which, if expended incident to the creation of a corporation or partnership having a limited life, would be amortizable over such life.

The Green Book indicates that a permanent doubling of currently deductible start-up expenses would support new business formation and job creation, and consolidating the provisions relating to expenditures incurred by new businesses would simplify tax administration and reduce new business owners' tax compliance burden.

### **Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance**

Substantially similar to last year's proposal, the administration's FY 2017 proposal would expand the group of employers that are eligible for this credit to include employers with up to 50 full-time equivalent employees, and would begin the phase-out at 20 full-time equivalent employees. In addition, the coordination of the phase-outs between the number of employees and the average wage would be amended to provide for a more gradual combined phase-out. The proposal also would eliminate a requirement that the employer make a uniform contribution on behalf of each employee, and eliminate the limit imposed by the rating area average premium.

The provision would be effective for tax years beginning after December 31, 2015.

### **Enhance and simplify research incentives**

The PATH Act made the research credit permanent, with taxpayers given two alternative methods of computing the research credit. The FY 2017 budget proposal would repeal the so-called traditional method, leaving the Alternative Simplified Credit (ASC) as the only available method. The rate of the ASC, imposed on incremental research spending in excess of a base amount, would be increased from 14% to 18%, and a special rule for start-up

companies that allowed them a flat rate credit of 6% of current year research spending would be repealed. The PATH Act allows certain small taxpayers to use their research credits against alternative minimum tax liability; the budget proposal would allow all taxpayers to do so. Seventy-five percent (75%), rather than the general 65%, of certain contract research payments to non-profit organizations (e.g., educational institutions) would be counted as research expenses in computing the credit. Also, the budget proposal would repeal rules that have limited the ability of an individual partner in a partnership or an S corporation shareholder to use a credit generated by the entity. Instead, they would be limited to offsetting the tax on the income generated by the entity for the year. In addition, individual taxpayers would no longer need to deduct their research expenditures over 10 years in computing alternative minimum tax.

The changes would be effective for research expenditures paid or incurred after 2016.

### **Extend and modify certain employment tax credits, including incentives for hiring veterans**

The Work Opportunity Credit (WOTC), which allows a credit to employers for the first-year wages paid to employees in targeted groups, would be made permanent, past its current reach of applying to employees who begin work before January 1, 2020. The targeted group of qualified veterans would be expanded for individuals who begin work after 2016 to include disabled veterans who use G.I. Bill benefits for training within one year after discharge, who are hired within six months after ending their training. The first \$12,000 of wages paid these veterans would be eligible for the WOTC.

A credit allowed for wages paid to individuals who are members of Indian tribes (and their spouses) and who, generally, live and work on a reservation, would be made permanent, past its current termination at the end of 2016. In tax years after 2016, the credit would be 20% of the amount of qualified wages and health insurance costs for an employee in excess of the average amount for the two preceding tax years.

## **OTHER BUSINESS TAX ITEMS**

### **Repeal last-in, first-out (LIFO) method of accounting for inventories**

Under current law, taxpayers may determine inventory values using the LIFO method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. To use the LIFO method for tax purposes, a taxpayer also must use LIFO for financial reporting (LIFO conformity rule).

The administration's FY 2017 proposal would repeal the use of the LIFO method for tax years beginning after December 31, 2016. Taxpayers that use LIFO would be required to change their method of inventory accounting, and include in income, prior years' LIFO reserves (the amount deferred under the LIFO method). The resulting section 481(a) adjustment (a one-

time increase in gross income) would be taken into account ratably over 10 tax years beginning with the year of change.

### **Repeal lower-of-cost-or-market (LCM) inventory accounting method**

Certain taxpayers are permitted to use the lower-of-cost-or-market (LCM) method, under which the taxpayer may write down the carrying values of eligible inventories to replacement or reproduction cost. A taxpayer also may write down the cost of subnormal (damaged) goods to reflect their decline in value.

The administration's FY 2017 proposal would repeal the use of the LCM and subnormal goods methods for the tax years beginning after December 31, 2016. Wash sale rules would prevent taxpayers from circumventing the prohibition. Compliance with these changes would be treated as a change in method of accounting for inventories, and any resulting section 481(a) adjustment would be included in gross income ratably over a four-year period beginning with the year of change.

#### **KPMG observation**

Repeal of LCM and subnormal goods writedowns would leave inventory (for tax purposes) at cost, including adjustments necessary under the uniform capitalization rules.

### **Reinstate corporate environmental income tax rate**

For periods beginning after December 31, 2016, the administration's FY 2017 proposal would reinstate and extend through December 31, 2026, the following Superfund excise taxes that were imposed before 1996:

- An excise tax on domestic crude oil and on imported petroleum products at a rate of \$0.097 per barrel. The tax would also be extended to crudes that had not previously been taxed, such as crudes produced from bituminous deposits, as well as kerogen-rich rock.
- An excise tax on listed hazardous chemicals at a rate that varied from \$0.22 to \$4.87 per ton (chemical excise tax).
- An excise tax on imported substances that use, as materials in their manufacture or production, one or more of the hazardous chemicals subject to the chemical excise tax.

The administration's FY 2016 budget would also reinstate the corporate environmental income tax at a rate of 0.12% on the amount by which the modified alternative minimum taxable income (determined without regard to the alternative tax net operating loss deduction and the deduction for the corporate environmental income tax) exceeded \$2 million.

The taxes would be dedicated to the Hazardous Substance Superfund Trust Fund.

## Eliminate fossil fuel tax preferences

As in last year's budget proposal, the administration's FY 2017 budget proposal would repeal several preferences currently available to the oil and gas sector, as listed:

- Repeal the section 43 enhanced oil recovery credit
- Repeal the section 45I credit for qualified crude oil and natural gas production from a marginal well
- Repeal the section 263(c) expensing of intangible drilling costs
- Repeal the section 193 deduction for tertiary injectants
- Repeal the section 469(c)(3) exception to passive loss limitation for working interests in oil and natural gas properties
- Repeal percentage depletion for oil and natural gas wells
- Repeal the section 199 domestic manufacturing deduction for oil and natural gas and coal and other hard mineral fossil fuels
- Increase geological and geophysical amortization period for independent producers to seven years under section 167(h)
- Repeal expensing of mining exploration and development costs
- Repeal percentage depletion for hard mineral fossil fuels
- Repeal capital gains treatment for coal and lignite royalties
- Repeal fossil fuel qualified income for publicly traded partnerships

### KPMG observation

Elsewhere in the FY 2017 budget, there is a proposal to limit the amount of capital gain deferred under the like-kind exchange rules to \$1 million per taxpayer, per tax year. This provision could make oil and gas unitizations and poolings, and mine aggregations taxable events.

## COMPLIANCE ITEMS

### Require Form W-2 reporting for employer contributions to defined contribution plans

Employers file Form W-2 to provide to each employee an annual statement showing the remuneration paid by the employer to the employee during the calendar year. A copy of the Form W-2 must also be filed with the Social Security Administration, which shares information on the form with the IRS. Employers are required to report an employee's elective deferrals under a cash or deferred arrangement, such as contributions to a 401(k) plan, on the employee's Form W-2. Employers are not currently required to report the employer's contributions to an employee's defined contribution retirement plan on the employee's Form W-2.

The administration's FY 2017 proposal would require employers to report the amounts an employer contributed to an employee's accounts under a defined contribution plan on the employee's Form W-2.

The proposal (included in previous budget proposals) would be effective for information returns due for calendar years beginning after December 31, 2016.

### **Increase certainty with respect to worker classification**

Under a special non-Code provision (*Section 530 of the Revenue Act of 1978*), the IRS is prohibited from reclassifying an independent contractor to employee status, even when the worker may be an employee under the common law rules, if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. In addition to providing so-called "Section 530 relief" to service recipients, the 1978 legislation prohibited the IRS from issuing guidance addressing the proper classification of workers.

The administration's FY 2017 proposal would allow the IRS to require service recipients to prospectively reclassify workers who are currently misclassified. It is anticipated that, after enactment, new enforcement activity would focus mainly on obtaining the proper worker classification prospectively, since in many cases, the proper classification of workers may have been unclear. In addition, the proposal would lift the prohibition on worker classification guidance, with Treasury and the IRS being directed to issue guidance that: (1) interprets the common law in a neutral manner; and (2) provides narrow safe harbors and/or rebuttable presumptions. Service recipients would be required to give notice to independent contractors explaining how they will be classified and the implications of such classification. Independent contractors receiving payments totaling \$600 or more in a calendar year from a service recipient would be permitted to require the service recipient to withhold federal income tax from their gross payments at a flat rate percentage selected by the contractor. The proposal would also clarify rules with respect to Tax Court jurisdiction in relevant proceedings and make technical and conforming changes to those rules.

The provision (included in previous budget proposals) would be effective upon enactment, but prospective reclassification of those workers covered by Section 530 would not be effective until the first calendar year beginning at least one year after the date of enactment. The transition period could be up to two years for independent contractors with existing written contracts establishing their status.

### **KPMG observation**

This proposal could result in a significant increase in costs and burdens on U.S. businesses that have service providers currently classified as independent contractors. The reclassification to employee status may have wide-spread implications outside of federal

employment taxes and affect such matters as workers compensation, unemployment benefits, pension requirements, and state employment taxes.

This provision was included in the administration's FY 2015 and 2016 revenue 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.

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