cutting through complexity

Tax Provisions in Administration's FY 2016 Budget Proposals

Compensation, Benefits, & Qualified Plans

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HIGHLIGHTS OF TAX PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2016 BUDGET RELATING TO COMPENSATION, BENEFITS, & QUALIFIED PLANS

KPMG has prepared a 111-page **book** that summarizes and makes observations about the revenue proposals in the Administration's FY 2016 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 relating to Compensation, Benefits, & Qualified Plans. Other booklets will address proposals relating to the following topics:

- International Tax
- General Corporate Tax
- Tax Accounting
- Business Tax Credits
- Financial Institutions & Products
- Passthrough Entities
- Closely Held Businesses & Their Owners
- Practice, Procedures, & Administration
- Charitable Deductions & Exempt Organizations
- Energy & Natural Resources
- Insurance
- Real Estate

Background

On February 2, 2015, President Obama transmitted to Congress the administration's recommendations to Congress for spending and taxation for the fiscal year that begins on October 1, 2015 (i.e., FY 2016).

Among many other things, the president proposed a six-year $478 billion program for transportation infrastructure, the cost of which would be offset in part by a one-time tax on the unrepatriated foreign earnings of U.S. multinational corporations. This tax would be part of a transition to a proposed fundamental change in the taxation of the future foreign earnings of U.S. corporations that would effectively eliminate deferral of tax on foreign earnings, causing them generally to be taxed on a current basis at a reduced rate.

The president also proposed a reserve for business tax reform, but not one of sufficient magnitude for significant rate reduction. The president has called for reducing the corporate income tax rate to 28%, but the budget does not provide revenue to offset the cost of such a reduction. Instead, the budget refers only to eliminating tax expenditures, such as accelerated depreciation and "reducing the tax preference for debt financed investment."

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Many of the “general” business tax proposals in the FY 2016 budget are familiar, having been raised in previous budgets. These proposals include, for example:

- Reforms to the international tax system
- Repeal of natural resources production preferences
- Repeal of LIFO and LCM accounting
- Taxation of carried interests in partnerships as ordinary income
- Insurance industry reforms
- Mark-to-market of financial derivatives
- Modification of the like-kind exchange rules
- Modification of the depreciation rules for corporate aircraft
- Denial of a deduction for punitive damages
- Make permanent and reform the credit for research and experimentation
- Make permanent the Subpart F exception for active financing income
- Make permanent look-through treatment of payments between related CFCs

The president also re-proposed a tax on the liabilities of financial institutions with assets in excess of $50 billion. The rate would be reduced relative to the prior proposal from 17 basis points to 7 basis points, but the base of the tax would be different and the application of the tax would be significantly broadened to include insurance companies, savings and loan holding companies, exchanges, asset managers, broker-dealers, specialty finance corporations, and financial captives. These changes have roughly doubled the revenue raised relative to the proposal in the FY 2015 budget.

The budget also includes a host of proposed changes to the individual income tax system. These include increasing the highest tax on capital gains from 23.8% (including the 3.8% net investment income tax) to 28%. In addition, a transfer of appreciated property would generally be treated as a sale of the property, subject to various exceptions and exclusions. For example, relief would be provided to lessen the immediate impact of the proposed change on the transfers of small businesses.

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Compensation, Benefits, & Qualified Plan Tax Proposals

Employment Taxes 4

Conform Self-Employment Contributions Act (SECA) taxes for professional service businesses 4

Make unemployment insurance surtax permanent 4

Expand Federal Unemployment Tax Act (FUTA) Base 5

Limit Value of Exclusions and Deductions for Certain Benefits and Contributions 5

Qualified Plans 6

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 6

Expand penalty-free withdrawals for long-term unemployed 7

Require retirement plans to allow long-term part-time workers to participate 7

Facilitate annuity portability 7

Simplify minimum required distribution (MRD) rules 8

Allow all inherited plan and IRA balances to be rolled over within 60 days 8

Require non-spouse beneficiaries of deceased IRA owners and retirement plan participants to take inherited distributions over no more than five years 8

Limit the total accrual of tax-favored retirement benefits 9

Limit Roth conversions to pre-tax dollars 10

Eliminate deduction for dividends on stock of publicly-traded corporations held in employee stock ownership plans 11

Repeal exclusion of net unrealized appreciation in employer securities 11

Employment-Related Tax Credits 11

Expand and simplify the tax credit provided to qualified small employers for non-elective contributions to employee health insurance 11

Repeal Federal Insurance Contributions Act (FICA) tip credit 12

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Employment Taxes

Conform Self-Employment Contributions Act (SECA) taxes for professional service businesses

As was the case for the previous fiscal year's budget proposal, the administration's FY 2016 proposal would change the employment tax rules with respect to professional services businesses that are passthrough entities. "Professional services businesses" would include S corporations and entities classified as partnerships for federal tax purposes, substantially all the activities of which 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. Thus, an expansive list of businesses would be covered.

Under the proposal, individual owners of professional services businesses that are passthrough entities would all be subject to Self-Employment Contributions Act (SECA) taxes in the same manner and to the same degree. More specifically, an individual owner and service provider who materially participates would be subject to SECA tax on his entire distributive share of passthrough income (subject to current law exceptions for items such as rents, dividends, and capital gains), while an owner who does not materially participate would be subject to SECA taxes only on an amount of income equal to "reasonable compensation," if any, for services provided to the business. Material participation generally would be determined using the section 469 rules, except that the exception for limited partners would not apply in the SECA context. Reasonable compensation would be as large as guaranteed payments received from the business for services. Distributions of compensation to shareholders of professional services businesses that are S corporations would no longer be treated as wages subject to Federal Insurance Contributions Act (FICA) taxes, but would be included in earnings subject to SECA taxes.

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

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. The 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.

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The administration's FY 2016 proposal would reinstate the 0.2% surtax and make it permanent.

The provision would be effective for wages paid on or after January 1, 2016.

Expand Federal Unemployment Tax Act (FUTA) Base

The administration's FY 2016 proposal would raise the FUTA wage base in 2017 to $40,000 per worker paid annually, index the wage base to wage growth for subsequent years, and reduce the net federal UI tax from 0.8% (after the proposed permanent reenactment and extension of the FUTA surtax) to 0.165%. States with wage bases below $40,000 would need to conform to the new FUTA base. States would maintain the ability to set their own tax rates, as under current law. The provision would impose a minimum tax rate requirement on states for their state employer tax rates equivalent to roughly $70 per employee beginning in 2017.

The provision would be effective upon the date of enactment.

KPMG observation

This provision modifies the previous budget proposal by increasing the FUTA wage base to $40,000 from the previously proposed $15,000. The current FUTA wage base is $7,000.

Limit Value of Exclusions and Deductions for Certain Benefits and Contributions

The administration's FY 2016 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.

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The Treasury Department's general explanation of the tax proposals of the budget—the so-called "**Green Book**"—does not describe in detail the mechanics of the proposed 28% limitation. In principle, however, taxpayers in the 36% 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 $3,600—a tax increase of $8 per $100 of itemized deductions compared with current law.

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

Qualified Plans

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 2016 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, 2016.

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Expand penalty-free withdrawals for long-term unemployed

The administration's FY 2016 proposal would expand the exception from the 10% additional tax for early withdrawal from a qualified retirement plan to include distributions to long-term unemployed individuals from an IRA, 401(k), or other tax-qualified defined contribution plan.

An individual would be eligible for this exception to the 10% additional tax on any distribution from an IRA, 401(k), or other tax-qualified defined contribution plan if the following conditions are met:

(1) The individual has been unemployed for more than 26 weeks by reason of a separation from employment and has received unemployment compensation for that period,

(2) The distribution is made during the tax year in which the unemployment compensation is paid or in the succeeding tax year

(3) The aggregate of all such distributions does not exceed certain annual limits

The exception would apply to distributions, but such distributions may not exceed half of the aggregate fair market value of the individual's IRAs, 401(k), and other tax-qualified defined contribution plans. However, an individual would be eligible for this exception for the first $10,000 of otherwise eligible distributions, even if that amount is greater than half the aggregate fair market value of such plan benefits.

The provision would apply to eligible distributions occurring after December 31, 2015.

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

The administration's FY 2016 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. The proposal would not require expanded eligibility to receive employer contributions such as matching contributions.

Employers would receive nondiscrimination testing relief from top-heavy vesting and top-heavy benefit requirements after expanding the eligibility group.

The provision would apply to plan years beginning after December 31, 2015.

Facilitate annuity portability

The administration's FY 2016 proposal would permit a plan to allow participants to take a distribution of a lifetime income investment through a direct rollover to an IRA or other retirement plan if the annuity investment is no longer authorized to be held under the plan. The distribution would not be subject to the 10% additional tax.

The proposal would be effective for plan years beginning after December 31, 2015.

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Simplify minimum required distribution (MRD) rules

Eliminate MRD requirements for balances of $100,000 or less

The administration's FY 2016 proposal would exempt an individual from the MRD requirements if the aggregate value of the individual's IRA and tax-favored retirement plan accumulations does not exceed $100,000 on the measurement date. However, benefits under qualified benefit pension plans that have begun to be paid in life annuity form would be excluded. The MRD requirements would phase-in ratably for individuals with aggregate retirement benefits between $100,000 and $110,000.

The provision would be effective for taxpayers attaining age 70½ years on or after December 31, 2015, and for taxpayers who die on or after December 31, 2015, before attaining age 70 ½ .

Harmonize MRD requirements for tax-favored retirement accounts

The administration's FY 2016 proposal would harmonize the application of the MRD requirements for holders of designated Roth accounts and Roth IRAs by generally treating Roth IRAs in the same manner as all other tax-favored retirement accounts, i.e., requiring distributions to begin shortly after age 70½. Individuals would not be permitted to make additional contributions to Roth IRAs after they reach age 70½.

The provision would be effective for individuals attaining age 70½ after December 31, 2015 and for taxpayers who die on or after December 31, 2015 before attaining age 70 ½ .

Allow all inherited plan and IRA balances to be rolled over within 60 days

The administration's FY 2016 proposal would expand the option available to a surviving non-spouse beneficiary under a tax-favored employer retirement plan or IRA for moving inherited-plan or IRA assets by allowing 60-day rollovers of such assets. This treatment would be available only if the beneficiary informs the new IRA provider that the IRA is being established as an inherited IRA, so that the IRA provider can title the IRA accordingly.

The provision would be effective for distributions after December 31, 2015.

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 2016 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. Eligible beneficiaries include 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

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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. However, 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.

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 provision would apply to distributions with respect to plan participants or IRA owners who die after December 31, 2015. 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, 2015, but only if the beneficiary dies after December 31, 2015. The provision 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.

Limit the total accrual of tax-favored retirement benefits

Under the administration's FY 2016 proposal, a taxpayer who has accumulated amounts within the tax-favored retirement system (i.e., IRAs, section 401(a) plans, section 403(b) plans, and funded section 457(b) arrangements maintained by governmental entities) in excess of the amount necessary to provide the maximum annuity permitted for a tax-qualified defined benefit plan under current law (currently an annual benefit of $210,000 payable in the form of a 100% joint and survivor benefit commencing at age 62 and continuing each year for the life of the participant and, if later, the life of the participant's spouse) would be prohibited from making additional contributions or receiving additional accruals under any of those arrangements. Currently, the maximum permitted accumulation for an individual age 62 years is approximately $3.4 million based upon the current AFR of 0.00000002%.

The limitation would be determined as of the end of a calendar year and would apply to contributions or accruals for the following calendar year. Plan sponsors and IRA trustees would report each participant's account balance as of the end of the year as well as the amount of any contribution to that account for the plan year. For a taxpayer who is under age 62, the accumulated account balance would be converted to an annuity payable at age 62, in the form of a 100% joint and survivor benefit using the actuarial assumptions that apply to converting between annuities and lump sums under defined benefit plans. For a taxpayer who is older than age 62, the accumulated account balance would be converted to an annuity payable in the same form, when actuarial equivalence is determined by treating the individual as if he or she was still age 62; the maximum permitted accumulation would continue to be adjusted for cost of

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living increases. Plan sponsors of defined benefit plans would report the amount of the accrued benefit and the accrual for the year, payable in the same form.

If a taxpayer reached the maximum permitted accumulation, no further contributions or accruals would be permitted, but the taxpayer's account balance could continue to grow with investment earnings and gains. If a taxpayer's investment return for a year was less than the rate of return built into the actuarial equivalence calculation (so that the updated calculation of the equivalent annuity is less than the maximum annuity for a tax-qualified defined benefit plan), there would be room to make additional contributions. In addition, when the maximum defined benefit level increases as a result of the cost-of-living adjustment, the maximum permitted accumulation would automatically increase as well. This also could allow a resumption of contributions for a taxpayer who previously was subject to a suspension of contributions by reason of the overall limitation.

If a taxpayer received a contribution or an accrual that would result in an accumulation in excess of the maximum permitted amount, the excess would be treated in a manner similar to the treatment of an excess deferral under current law. Thus, the taxpayer would have to include the amount of the resulting excess accumulation in current income and would be allowed a grace period during which the taxpayer could withdraw the excess from the account or plan in order to comply with the limit. If the taxpayer did not withdraw the excess contribution (or excess accrual), then the excess amounts and attributable earnings would be subject to income tax when distributed, without any adjustment for basis (and without regard to whether the distribution is made from a Roth IRA or a designated Roth account within a plan).

The provision would be effective with respect to contributions and accruals for tax years beginning on or after December 31, 2015.

Limit Roth conversions to pre-tax dollars

The administration's FY 2016 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, 2015.

KPMG observation

This provision is new to the FY 2016 budget.

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Eliminate deduction for dividends on stock of publicly-traded corporations held in employee stock ownership plans

The administration's FY 2016 proposal would repeal the deduction for dividends paid with respect to employer stock held by an ESOP that is sponsored by a publicly traded corporation. Rules allowing for immediate payment of an applicable dividend would continue, as would rules permitting the use of an applicable dividend to repay a loan used by the ESOP to purchase the stock of the publicly traded corporation. The Secretary would continue to have authority to disallow an unreasonable dividend or distribution (as described in section 1368(a)) for this purpose.

The proposal would apply to dividends and distributions that are paid after the date of enactment.

Repeal exclusion of net unrealized appreciation in employer securities

The administration's FY 2016 proposal would repeal the exclusion of net unrealized appreciation in employer stock in the year of a distribution for participants in tax-qualified retirement plans who have not yet attained age 50 as of December 31, 2015. Participants who have attained age 50 on or before December 31, 2015 would not be affected by the provision.

The provisions would apply to distributions made after December 31, 2015.

Employment-Related Tax Credits

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

The *Affordable Care Act of 2010* created a tax credit designed to help small employers provide health insurance for their employees and their employees' families. To qualify for the credit, an employer must make uniform contributions of at least 50% of the premium. A qualified employer is one with no more than 25 full-time equivalent employees during the tax year and whose employees have annual full-time equivalent wages that average no more than $50,000 (indexed for inflation beginning in 2014.)

The credit is phased out on a sliding scale for employers with between 10 and 25 full-time equivalent employees, and also for average annual employee wages between $25,000 and $50,000 (these amounts are indexed for inflation.)

The administration's FY 2016 proposal would expand the group of employers that are eligible for the 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

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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, 2014.

Repeal Federal Insurance Contributions Act (FICA) tip credit

The administration's FY 2016 proposal would repeal the income tax credit for FICA taxes an employer pays on tips. Currently, tip income is treated as employer-provided wages subject to employment taxes under FICA. Employers are responsible for withholding and reporting the employee's portion of FICA and paying the employer's portion of FICA. An eligible employer may claim a credit against the business's income taxes for FICA taxes paid on certain tip wages.

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

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