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KPMG's U.S. Japanese Practice

JNET NEWSLETTER

U.S. business update for Japanese companies

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Contents

Competitive Alternatives 2014

A Guide to Business Location Costs

Competitive Alternatives 2014 compares business costs and other competitiveness factors in more than 100 cities, in 10 countries: Australia, Canada, France, Germany, Italy, Japan, Mexico, the Netherlands, the United Kingdom, and the United States. For 2014, Competitive Alternatives further expands its coverage in the US, and for the first time includes every US metro area with a population of two million or more.

The primary focus of *Competitive Alternatives* is international business costs. The study measures the combined impact of 26 key cost components that vary by location, over a 10-year analysis horizon starting in 2014. The study compares 7 different business-to-business (B2B) service sector operations and 12 different manufacturing sector operations.

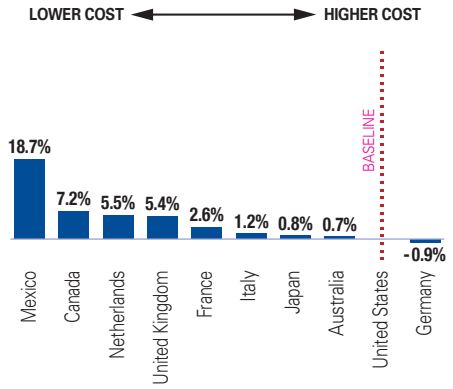
The overall cost comparisons for each country and city are based on the average results for these two sectors.

Competitive Alternatives also provides important information on non-cost factors that influence the business attractiveness of different locations. Aspects addressed by the study include labor availability and skills, economic conditions, innovation, infrastructure, regulatory environment, cost of living, and personal quality of life factors.

Competitive Alternatives is a biennial KPMG study that focuses on business locations in the NAFTA marketplace, as well as leading mature market countries in Europe and Asia Pacific. This study contains valuable information for any company considering international business location options.

2014 Findings

The four largest US metro areas — New York City, Los Angeles, Chicago, and Dallas-Fort Worth — form the US baseline against which costs for major cities in other countries are compared to determine the national results.



% cost advantage/disadvantage relative to US.
SOURCE: Competitive Alternatives, KPMG LLP (Canada), 2014

Mexico, the lowest-cost country examined, is the only high growth (emerging) country included in the study. As a NAFTA member, Mexico's 18.7 percent cost advantage over the United States in 2014 is similar to 2010. With little change in the value of the Mexican peso over that four year period, Mexico's cost advantage relative to its northern neighbor has been holding steady.

Canada ranks second among the 10 countries, with business costs 7.2 percent lower than in the United States. Moving ahead of both the Netherlands and the **United Kingdom**, Canada re-establishes a competitive advantage over these countries seen in 2010 and earlier editions of Competitive Alternatives.

Costs in the **Netherlands** (third) and the United Kingdom (fourth) are similar, at 5.5 and 5.4 percent (respectively) below

the US baseline—essentially unchanged from 2012 although their rankings swap in 2014.

France and **Italy** rank fifth and sixth in the standings, and continue to represent midcost countries among the mature market nations.

The final four countries are tightly grouped, with a significant convergence of business costs in recent years and all with business costs within one percent of the US baseline. **Japan** and **Australia** have moved ahead of the **United States** since 2012, leaving **Germany** as the only country with business costs higher than the US.

Big Gains for Japan

The most dramatic change in the international cost competitiveness rankings in 2014 is a big gain for Japan. Japan now ranks in seventh place among the 10 nations, and ahead of the United States for the first time since Japan joined **Competitive Alternatives** in 1999.

Years of low inflation allowed Japan to gradually improve its competitive position during the 2000s, even as the yen appreciated. Now, with a significant drop in the value of the yen over the last two years, we are witnessing a new paradigm in Japan's global cost competitiveness.

Key Cost Factors

Labor costs represent the single largest location-sensitive cost factor for all industries examined. For service operations, labor typically represents approximately 75 to 90 percent of total locationsensitive costs, while the typical range for manufacturing operations is 45 to 60 percent of location-sensitive costs.

Labor costs represent the single largest location-sensitive cost factor for all industries examined. For service operations, labor typically represents approximately 75 to 90 percent of total location sensitive costs, while the typical range for manufacturing operations is 45 to 60 percent of location-sensitive costs.

Labor comparisons are based on a mix of 42 job positions, which vary by industry. Labor costs comprise wages and salaries, statutory costs (payroll taxes, government pension plans, medical plans, etc.), and other benefits typically provided by employers. Combining these elements, total labor costs are lowest in Mexico by a wide margin, followed by the United Kingdom, Canada, and Italy.

Facility costs vary both by location and type of business operation:

- For services operations, office lease costs average approximately 9 percent of total location-sensitive costs. Office lease costs are lowest in the Netherlands, Mexico, and Germany.
- For manufacturing, factory lease costs average approximately 4 percent of total location-sensitive costs for the operations examined. Industrial lease costs are lowest in the United States, the Netherlands, and Mexico.

Transportation costs vary widely by industry, typically representing 7 to 24 percent of location-sensitive costs for manufacturing operations. Transportation costs vary by product and markets served. The countries with the lowest transportation costs for the business operations examined are Japan, the United States, and Germany.

Utility costs represent up to 8 percent of total location-sensitive costs. Electricity costs are lowest in the United States, Canada, and the Netherlands, while natural gas costs are lowest in Mexico, the United States, and Canada.

Taxes, Taxes, Taxes

Taxes typically represent up to 14 percent of location-sensitive costs across the locations and operations examined. Effective **corporate income tax rates**, calculated net of generally applicable tax credits and incentives, vary by business sector:

- For **digital services** operations, Canada, the United Kingdom, and France offer the lowest effective corporate income tax rates.
- For **research and development** operations, many of the countries studied offer significant R&D tax incentives. France, the Netherlands, and Canada offer the lowest effective tax rates in this subsector.

  For **corporate services**, the United Kingdom, Canada, and the Netherlands offer the lowest effective rates of corporate income tax.

  For **manufacturing** operations, the United Kingdom, Canada, and the Netherlands also offer the lowest effective corporate tax rates.

Exchange Rates

All study results are sensitive to exchange rates. The exchange rates used in this edition of Competitive Alternatives are as follows:

Exchange Rates[1]

	2012 Edition	2014 Edition[2]	Change[3]
Australian $	0.99	1.08	-8.3%
Canadian $	1.02	1.05	-2.9%
Euro €	0.74	0.73	1.4%
Japanese ¥	77.33	100.43	-23.0%
Mexican peso	13.64	13.02	4.8%
UK £	0.64	0.62	3.2%

1. Per US$.
2. Average exchange rates for October-December 2013.
3. Two-year appreciation/depreciation relative to US$.

Business Cost Trends

The following table tracks the change in business costs over the last two years for all 10 countries. Japan and Australia have seen the greatest changes in business costs, consistent with the depreciation of their currencies shown in the table above.

Business Cost Index

	2012 Edition	2014 Edition	Change[1]
Australia	103.7	99.3	-4.4
Canada	95.0	92.8	-2.2
France	96.1	97.4	+1.3
Germany	100.1	100.9	+0.8
Italy	97.9	98.8	-0.9
Japan	109.4	99.2	-10.2
Mexico	79.0	81.3	+2.3
Netherlands	94.7	94.5	-0.2
United Kingdom	94.5	94.6	+0.1
United States	100.0	100.0	–

1. Increase in cost index represents an increase in relative business costs since 2012.

For more information, download the full report below.

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Competitive Alternatives 2014 >

http://www.kpmg.com/US/en/industry/Japanese-Practice/Documents/2014-issue4/Competitive%20Alternatives%202014%20(E).pdf

Questions?

If you have any questions about this article please reach out to your KPMG engagement team or email us at us-kpmg-jp@kpmg.com.

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Global Manufacturing Outlook: Performance in the Crosshairs

The 2014 *Global Manufacturing Outlook: Performance in the crosshairs* report examines the continuing evolution of the strategies that manufacturers are deploying to drive value and performance across the enterprise.

As evidenced in the survey results, explosive developments in technology, material science, advanced manufacturing and synergistic operating models are clearly beginning to redefine 'the art of the possible' and are changing the way manufacturing companies compete and succeed.

Manufacturers are still overwhelmingly focused on profitable growth. And this year's Global Manufacturing Outlook (GMO) identifies a wide variety of strategies to achieve it. Increasing levels of supply chain transparency and visibility; improving use of data, analytics and business intelligence tools; integration of new technologies; and a continuation of the trend towards greater partnerships and collaborative business models are at the forefront of these strategies.

But new strategies also bring new challenges and complexities. Based on this year's report, there is clearly much work still to be done to leverage the power of these business models, tools and technologies to ultimately overcome the omplexities of data proliferation, the accelerating pace of change and disruptive innovation across the sector.

Key findings from the 2014 report include:

- Manufacturers are focused on understanding their product cost and profitability. Only 12 percent of respondents said they were 'very effective' at determining product profitability. Many suggest that they plan to commit either moderate or significant investment into enhancing their systems and processes for profit and cost information. More than half say that – over the next two years – they will place either a moderate or high priority on to adopting processes and systems to achieve the real-time measurement of product cost and profitability.
- Organizations are rethinking their product development strategy. Respondents are increasingly focused on enhanced spending, shifting towards breakthrough innovation objectives and exploring new collaborative business models to create competitive advantage. Seventy percent of respondents said they would double their level of spend in R&D. Yet at the same time, 88 percent said that partnerships, not in-house efforts, would form the future of innovation. Technology is also coming into play; three-quarters of respondents say they are better leveraging decision-support technology in their R&D function.
- Supply chain transparency and visibility remain a key challenge for manufacturers. Forty percent of respondents admit they lack visibility across their extended supply chain, with 33 percent saying it was due to either inadequate IT systems or a lack of skills. Our research suggests that many of the gains in supply chain visibility have resulted from stronger relationships between manufacturers and their top-tier suppliers and the willingness to share more real-time data across the value chain.
- A majority of respondents think that they could achieve a globally integrated supply chain within the next three to five years. More than half say that they use global demand planning and global capacity planning technologies in their supply chain enterprise-wide. More than three-quarters say that their relationship with top tier suppliers is now strong enough for them to share real-time capacity and demand data.

For more information, download the full report below.

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2014 Global Manufacturing Outlook: Performance in the Crosshairs >

http://www.kpmg.com/US/en/industry/Japanese-Practice/Documents/2014-issue4/2014GlobalManufacturingOutlookPerformanceinthecrosshairs.pdf

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If you have any questions about this article please reach out to your KPMG engagement team or email us at us-kpmg-jp@kpmg.com.

Over the Horizon: How Corporate Counsel are Crossing Frontiers to Address New Challenges

KPMG has been offering insights into the role of General Counsel for many years. In 2012, we published *Beyond the Law*, a global study of how General Counsel (GC) are turning risk to advantage, which was based on a telephone survey of GCs around the world. The 2014 analysis explores more fully some of the findings of the previous study and consists of in-depth interviews with GC and other senior counsel in Europe, North America and Asia-Pacific (see page-2).

The 2012 analysis found that GC were being called upon to play a more important role in how businesses operate and to move from being a pure legal counsellor to a business advisor. The study highlighted some of the challenges GC were facing as a result of their broadening roles. The 2014 analysis explores some of the themes that emerged from the 2012 survey to show how GC are managing different kinds of risk and guiding corporate conduct. The evidence gathered from these new interviews demonstrates how many GC are becoming increasingly involved in matters that are not strictly legal, such as risk management and business strategy. As they continue this transition to a broader role, it is likely that even more will be expected from GC by the Board and senior management. GC will continue to rise to the challenge.

For more information, download the full report below.

Download Now
Over the Horizon: How Corporate Counsel are Crossing Frontiers to Address New Challenges >

http://www.kpmg.com/US/en/industry/Japanese-Practice/Documents/2014-issue4/Over%20the%20Horizon.pdf

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Auditing & Accounting Update

In this section, we provide brief updates on regulatory developments in auditing and accounting that may impact Japanese companies in the United States. Further discussion of the issues can be found in KPMG's Department of Professional Practice's **Defining Issues** http://search.kpmginstitutes.com/?bigi=1&q=Defining+Issues&x=0&y=0

FASB Decides on Accounting for Equity Investments and Disclosures for Core Deposits

At its July 30 meeting, the FASB decided that changes in the fair value of investments in equity securities would not be reported through other comprehensive income and that public business entities would be required to disclose their core deposit liability balance and the historical weighted-average life of the core deposit liability balance disaggregated by significant types of core deposit accounts.

Go to Defining Issues 14-35 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/DI-14-35_equity_investments.pdf

New Revenue Recognition Standard: Potential Tax Implications

Changes in the timing or amount of revenue recognized by some entities under the new revenue recognition standard issued in May 2014 by the FASB and the IASB may affect the calculation of and financial reporting for income taxes and other types of taxes.

Changes in financial reporting for revenue may affect taxes by:

- Accelerating taxable income because tax accounting methods changed;
- Creating or changing existing temporary differences in accounting for income taxes for financial reporting purposes;
- Requiring revisions to transfer pricing strategies and documentation;
- Requiring updated policies, systems, processes, and controls related to income tax accounting and financial accounting; and
- Changing sales or excise taxes because revenue may be recharacterized between product and service revenue.

Go to Defining Issues 14-36 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-36-revenue-tax-implications.pdf

FASB Redeliberates Impairment of Debt Securities and Measurement of Credit Losses

At its August 13 meeting, the FASB continued redeliberations on its proposed standard on financial instrument impairment and discussed (1) whether the lifetime expected credit loss model would apply to debt securities and (2) the measurement of expected credit losses. The FASB tentatively decided that debt securities classified as available-for-sale will continue to apply an other-than-temporary impairment (OTTI) model and, therefore, would be excluded from the scope of the expected credit loss model. Targeted amendments to the current OTTI model will be made to address concerns about the timely recognition of credit losses.

Go to Defining Issues 14-37 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-37-impairment.pdf

FASB Considers Impairment for Equity Investments, Disclosures for Embedded Derivatives

At its August 20 meeting, the FASB continued redeliberations on its proposed financial instruments classification and measurement standard and addressed the impairment of investments in equity

securities not measured at fair value with changes in fair value recognized in net income. The Board affirmed that entities would use a one-step impairment model to assess equity investments measured at cost minus impairment, adjusted for observable price changes.

The Board also addressed enhancements to disclosures about hybrid financial instruments that contain bifurcated embedded derivatives and decided to expose this issue for public comment either as a separate project or as part of an existing project.

Go to Defining Issues 14-38 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-38-impairment-equity.pdf

FASB Proposes Guidance for Customer's Accounting for Cloud Computing Services

At its August 20 meeting, the FASB issued a proposed ASU Customer's Accounting for Fees Paid in a Cloud Computing Arrangement to provide guidance about whether a customer has acquired a software license, services, or both.

Go to Defining Issues 14-39 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-39-cloud-computing.pdf

FASB Issues Going Concern Standard

In August 2014, the FASB issued a new going concern standard, which describes how an entity should assess its ability to meet obligations and sets disclosure requirements for how this information should be disclosed in the financial statements. The standard provides accounting guidance that will be used with existing auditing standards. The new standard applies to all entities for the first annual period ending after December 15, 2016, and interim periods thereafter.

Go to Defining Issues 14-40 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/DI-14-40_going_concern.pdf

SEC Adopts Regulation AB II

In August, 2014, the SEC unanimously voted to adopt the much anticipated asset-backed securities (ABS) final rules and the amendment for Regulation AB. The final rules respond to the financial crisis and addressed regulatory concerns about the structured finance product marketplace, and are intended to restore investor confidence by enhancing the disclosure, reporting, and offering process for ABS.

Go to Defining Issues 14-41 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-41-abs.pdf

SEC Staff Provides Relief for Retrospective Revenue Adopters

On September 11, the SEC staff stated that it will not object if registrants that apply the new revenue recognition standard retrospectively apply the standard to only the periods covered by the financial statements. Under Regulation S-K, registrants are required to disclose at least five years of selected financial data to highlight significant trends in financial condition and the results of operations. While SEC staff guidance indicates that it generally expects all periods presented in selected financial data to be presented on a consistent basis with the financial statements, the SEC staff would not object if registrants elect to apply the new standard to only the periods covered by the financial statements, as long as they clearly disclose that the financial data for the earlier years was not retrospectively adjusted.

Go to Defining Issues 14-43 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-43-sec-relief-retrospective-adopters.pdf

EITF Reaches 2 Final Consensuses, 2 Consensuses-for-Exposure

At its September 18 meeting, the FASB's Emerging Issues Task Force discussed four issues and reached final Consensuses on Issue 12-F, Recognition of New Accounting Basis (Pushdown) in Certain Circumstances, and Issue 13-G, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or Equity. The Task Force also reached Consensuses-for-Exposure on Issue 14-A, Effects of Historical Earnings per Unit of Master Limited Partnership Dropdown Transactions, and Issue 14-B, Fair Value Hierarchy Levels of Certain Investments Measured at Net Asset Value.

Go to Defining Issues 14-44 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-44-eitf.pdf

FASB Issues Two More Simplification Exposure Drafts

On October 14, the FASB issued two proposed ASUs as part of its initiative to reduce unnecessary complexity in GAAP. Debt issuance cost would be presented in the balance sheet as a direct deduction from the debt liability, consistent with the accounting treatment of debt discounts. Also, a practical expedient would be provided to employers with fiscal year-ends that do not fall on a month-end to permit them to measure defined benefit obligation and plan assets using the month-end closest to the entity's fiscal year-end.

Go to Defining Issues 14-45 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-45-fasb-issues-two-simplification-drafts.pdf

FASB and IASB Enter Home Stretch in Redeliberations on Lease Accounting - but on Different Tracks

The FASB and IASB's redeliberations during July and October 2014 about the proposals in their 2013 Exposure Drafts on lease accounting. The Boards jointly discussed sale-leaseback transactions, the definition of a lease, and lessor disclosures. The FASB also met separately in August to discuss sale-leaseback transactions and aspects of the proposals that apply to U.S. GAAP only, including leveraged leases, nonpublic lessee discount rates, and related party leasing transactions. As has been the case in each joint meeting since March 2014, while the Boards reached converged decisions in the reconsideration of some of their proposals, there were key areas on which they do not agree.

Go to Defining Issues 14-46 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-46-fasb-iasb-redeliberate-leases.pdf

FASB to Propose Changes to Accounting for Income Taxes for Intercompany Transfers and the Presentation of Deferred Taxes

At its October 22 meeting, the FASB decided to propose changes to accounting for income taxes to require recognition of the income tax consequences of intercompany asset transfers and to classify all deferred tax assets and liabilities as noncurrent in a classified statement of financial position. The Board expects to issue a proposed ASU in early 2015.

Go to Defining Issues 14-47 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-47-fasb-proposes-changes-income-tax-accounting.pdf

Actuaries Issue New Mortality Data That May Affect Retirement Benefit Obligations

In October 2014, the Society of Actuaries (SOA) released updated mortality tables and the mortality improvement scale. The updated mortality data reflect increasing life expectancies in the United States. Companies should consider the SOA's new mortality data for U.S.-based defined benefit pension and other postretirement benefit plans when making their mortality assumptions for year-end 2014 financial reporting.

Go to Defining Issues 14-48 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-48-mortality-data.pdf

Go to Defining Issues 14-42 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-42-mortality-data.pdf

Questions?

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Tax Update

In this section of Jnet, we provide brief updates on legislative, judicial, and administrative developments in tax that may impact Japanese companies operating in the United States.

October 2014

More Time Allowed under Temporary Regulations to Coordinate FATCA Compliance Provisions

On October 10, the IRS released Notice 2014-59 announcing that Treasury and the IRS intend to amend the temporary regulations that were issued earlier this year in order to modify and coordinate certain provisions under the information reporting and withholding rules under the FATCA regime.

Notice 2014-59 modifies the dates when provisions of the temporary regulations apply concerning:

- The standards of knowledge—i.e., the circumstance when a withholding agent has reason to know that a payee's claim of foreign status is unreliable or incorrect
- The documentary evidence standard — when an amount is considered paid outside the United States and the types of documentary evidence permitted for establishing a payee's foreign status for certain payments

As temporary regulations were issued earlier in 2014, the IRS issued Notice 2014-33 in May 2014, announcing that 2014 and 2015 would be treated as transition years for purposes of (1) IRS enforcement and administration with respect to the implementation of FATCA by withholding agents, foreign financial institutions (FFIs), and certain other entities; and (2) with respect to certain related due diligence and withholding provisions.

Notice 2014-59 was issued in response to comments received following the release of Notice 2014-33. Notice 2014-59 states that additional time is being provided for withholding agents to apply the new entity account procedures to document a new obligation held by an entity and to further facilitate the relief provided by Notice 2014-33. Treasury and the IRS also intend to modify the revised standard of knowledge in the temporary regulations to reflect this additional time. Further, Notice 2014-59 states that Treasury and the IRS intend to modify the temporary regulations to provide that, for an obligation held by an entity, a withholding agent will not be required to treat the additional U.S. indicia as a change in circumstances before January 1, 2015.

Concerning the documentary evidence standard for certain offshore payments, Notice 2014-59 allows payors additional time to modify their systems to implement the revised requirements under the temporary regulations. This change will allow a payor to continue to use, for accounts opened after July 1, 2014, and before January 1, 2015, the rules regarding the use of documentary evidence as under the regulations that were in effect as of April 2013 (instead of the 2014 temporary regulations).

Tax Court: Wages Found not "Reasonable" and Denied a Research Credit

The U.S. Tax Court issued a memorandum opinion addressing, in a case of first impression, whether wages are to be disallowed as qualified research expenses (QREs) in computing the research credit because the wages did not satisfy the requirement in section 174(e)—i.e., a taxpayer may deduct a research and

development expenditure under section 174 only to the extent that "the amount thereof is reasonable under the circumstances. " Suder v. Commissioner, T.C. Memo 2014-201 (October 1, 2014)

At issue were research credits claimed on returns for 2004 through 2007 by the shareholders of an S corporation that developed telephone systems and technology for small and mid-sized businesses. For the years at issue, the company founder was the CEO, a 90% shareholder, and was integrally involved in product development. Most of the QREs related to the wages paid to the CEO / principal shareholder. He had aggregate compensation ranging from $8 million to $10 million in each of the years.

The IRS denied, in full, the total amount of research credits claimed by the shareholders for the four years, about $2 million in all.

Under regulations, the amount of an expenditure is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. The Tax Court considered this issue strictly as a question of whether the wages would meet the requirement under section 162(a)(1)—a taxpayer may deduct "…a reasonable allowance for salaries or other compensation for personal services actually rendered.

After hearing extensive expert witness testimony, the Tax Court decided that the CEO's wages were not reasonable and determined that a reasonable amount was closer to $2.5 million a year. Other testimony established that about 75% of the CEO's time was spent in qualifying activities, and the court held that 75% of the reasonable amount was the correct amount of wage QREs that could be claimed for his activities.

California: Two Entities Not Unitary

The California Superior Court of Los Angeles County addressed whether a cable company taxpayer and a home shopping channel subsidiary were engaged in a unitary business and should be required to file tax returns on a combined basis.

In addressing whether the cable company and the home shopping channel in which it owned a majority interest were engaged in a unitary business, the court first analyzed whether centralized management, functional integration, and economies of scale — the three hallmarks of the unitary business principle — existed between the entities. Relying primarily on testimony from executives from both companies, the court determined that after the taxpayer acquired a majority interest in the channel, the companies continued to operate independently of each other and that there was no evidence that the taxpayer exerted any control over the channel, or changed any of its operations. Likewise, the court found no evidence of functional integration or economies of scale. Specifically, no attempts were made to consolidate functions and there was no opportunity for centralized purchasing given the difference between the businesses.

The court next addressed the FTB's primary contention- that the carriage agreement between the taxpayer and the channel was the basis for a unitary relationship. However, the agreement was put in place prior to the taxpayer acquiring a majority interest in the channel and the agreement reflected the same arm's length market terms the channel offered every other major cable and satellite distributor. In addition, the channel was not given any preferential treatment (i.e., more extensive coverage).

Finally, the court rejected the FTB's view that a joint venture between the parties- a wedding planning website- evidenced a unitary relationship. In the court's view, the fact that the venture was carefully structured as a separate joint venture supported a conclusion that the entities were not unitary.

Finance Chairman Responds to IRS Commissioner's Letter Urging Action on Tax Extenders

On October 7, Senate Finance Committee Chairman Ron Wyden (D-OR), in response to a letter from IRS Commissioner John Koskinen, said that Congress needs "to act swiftly" with respect to the expired tax extenders. The chairman's statement, released by the Finance Committee, addresses what he referred to as the "damaging uncertainty" because of congressional inaction on the tax extenders.

IRS Commissioner Koskinen, in his October 6 letter to the Finance Chairman noted there is a "great deal of uncertainty" relating to the expired provisions and wrote that "… it would be detrimental to the entire 2015 tax filing season…if Congress fails to provide a clear policy direction before the end of November." The Commissioner's letter further states that, if Congress waits until 2015 and then enacts retroactive tax law changes affecting 2014, the operational and compliance challenges would be even more severe — likely resulting in service disruptions, millions of taxpayers needing to file amended returns, and substantially delayed refunds.

September 2014

IRS Notice to Address Corporate Inversion Transactions

On September 22, the Treasury Department announced the issuance of IRS Notice 2014-52 to take "targeted action to reduce the tax benefits of — and when possible, stop — corporate tax inversions" which is a technique that may be used by a U.S. company to merge with a foreign company so that it can become domiciled in a low tax jurisdiction. Notice 2014-52 describes regulations that Treasury and the IRS intend to issue regulations that will take two approaches to counter the recent increase in corporate inversions: (1) minimizing the new foreign parent's ability to access, in a tax efficient manner, controlled foreign corporation (CFC) cash and operations following an inversion; and (2) tightening the anti-inversion rules in section 7874 to treat more inverted companies as domestic corporations. Treasury's press release stated that "[f]or some companies considering mergers, today's action will mean that inversions no longer make economic sense."

1. Increasing the costs of inversion by limiting access to CFC cash

Notice 2014-52 indicates that the following rules will apply to inversion transactions completed on or after September 22, 2014 if (1) the new multinational entity does not have at least 25% of the income, assets and employees in the home country of the new foreign parent over a specified period of time; and (2) the shareholders of the old U.S. parent end up owning less than 80% of the shares of the new foreign parent so that the inversion transaction would be respected but own at least 60% of such foreign parent:

- Anti-hopscotching: Under current law, if a CFC tries to avoid tax on deferred earnings by investing in certain U.S. property — such as by making a loan to, or investing in stock of, its U.S. parent or one of its domestic affiliates — the U.S. parent is treated as if it received a taxable dividend from the CFC. However, loans from or equity investments by a CFC to a foreign parent, as may arise following an inversion transaction, are not considered U.S. property and, therefore, do not give rise to a U.S. income inclusion. The rules described in Notice 2014-52 purport to remove the benefits of these "hopscotch" transactions by providing that such loans or equity are considered "U.S. property" for purposes of applying the anti-avoidance rule.
- Anti-dilution provisions: Following a combination of U.S. and foreign companies, the new foreign group may undertake to integrate its foreign operations with the U.S. company's CFCs. This integration can result in diluted U.S. ownership of the CFCs, and may lead to loss of CFC status if the foreign parent's ownership exceeds 50% thereby allowing the new foreign parent to access the deferred earnings of the CFC without ever paying U.S. tax on them. Under the rules described in Notice 2014-52, investments by the new foreign parent in a CFC would be treated as if the new foreign parent owned stock in the former U.S. parent. Therefore, the CFC would remain a CFC, and the U.S. parent would continue to be subject to U.S. tax on repatriation of the CFC's deferred earnings. In addition, the new rules would require a U.S. income inclusion for restructuring transactions that reduce the U.S. group's ownership of a CFC, but that do not eliminate CFC status.
- Addressing sale of U.S. parent stock: Some transactions involve the new foreign parent selling its stock in the former U.S. parent to a CFC, which could result in a deemed dividend being paid directly from the CFC to the new foreign parent effectively resulting in a tax-free repatriation of cash or property bypassing the U.S. parent. The new rules are introduced to eliminate the ability to use this strategy.

2. Tightening anti-inversion rules

- Disregarding stock attributable to passive assets: Under current law, the relative sizes of the U.S. and foreign merger parties would determine whether and how the inversion rules would apply (e.g., 80% and 60% mentioned above) but certain stock issued in an initial public offering connected with the inversion is disregarded in determining these relative sizes. Also, Treasury and the IRS have previously exercised the regulatory authority to disregard stock in the foreign merger party that is acquired in a private placement or otherwise for cash and certain other passive assets. The rules described in Notice 2014-52 further expand this rule by disregarding stock of the foreign parent that is attributable to passive assets if at least 50% of the foreign group's assets are passive. Banks and certain other financial services companies would be exempted.
- Addressing "skinny-down" transactions: The rules described in Notice 2014-52 would increase the value of U.S. corporations to the extent of their "non-ordinary course distributions." A non-ordinary course distribution is defined as the excess of all distributions by a U.S. company during a tax year over 110% of

the average of such distributions over the 36 months preceding the test year.

- Addressing "spinversion": Notice 2014-52 announces rules to amend current regulations that permit, in certain circumstances, a U.S. company from contributing the stock or assets of a U.S. company to a foreign subsidiary and spinning that foreign subsidiary off to its shareholders (sometimes referred to as a "spinversion"). Notice 2014-52 would introduce the rules to limit the ability to form a foreign subsidiary for such purpose.

Notice 2014-52 announces that Treasury and the IRS are considering further guidance to address inversions, and, in particular, guidance to address U.S. base erosion through debt or otherwise (i.e., earnings stripping). Notice 2014-52 also requests comments on the potential scope of such rules and provides that such base erosion guidance will be prospective, but warns that, if such guidance only addresses inverted groups, it will nevertheless apply to groups completing inversion transactions on or after September 22, 2014

Revenue Procedure on Dispositions of Tangible Depreciable Property

On September 18, the IRS released Rev. Proc. 2014-54 concerning changes in the method of accounting for dispositions of tangible depreciable property. In 93 pages of guidance, the revenue procedure sets forth the procedures by which a taxpayer may obtain the automatic consent of the Commissioner to change to the methods of accounting provided in the recently issued final regulations concerning the rules for disposition of tangible depreciable property.

GAO Report - Need for Improved IRS Audit Efficiency of Large Partnerships

On September 18, the U.S. Government Accountability Office (GAO) released a report that addresses how the IRS may improve audit efficiency with respect to tax examinations of large partnerships. The GAO report—Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, GAO-14-732 (September 18, 2014) — recommends legislative action that would allow the IRS to adjust the partnership's return, instead of the returns of the partners. The number of large partnerships has more than tripled to 10,099 from 2002 to 2011, and almost two thirds of large partnerships had more than 1000 partners and six or more tiers. Many of the large partnerships are in the finance and insurance sector with many being investment funds.

August 2014

Final Regulations - Tangible Asset Dispositions

On August 14, the Treasury Department and IRS released final regulations (T.D. 9689) regarding the tax treatment of tangible asset dispositions. The final regulations largely finalize, without significant change, proposed regulations that were issued in late 2013 along with the final "repair regulations."

The changes made by the final regulations are relatively minor, and relate mainly to the identification and computation of the tax basis of the disposed asset in specific circumstances. For example, the regulations provide specific rules for determining the basis of disposed of assets such as building roofs, HVAC, etc.

The final disposition regulations apply to tax years beginning on or after January 1, 2014. However, taxpayers may choose to apply either the 2013 proposed regulations or the 2011 temporary regulations to tax years beginning on or after January 1, 2012 and beginning before January 1, 2014.

Tax Court - Six-Year Limitations is Based on Gains from Investment Sales, not the Amounts of Sales Realized

On August 28, the U.S. Tax Court issued an opinion on whether "gross income" includes gains from the sale of investment assets or the entire amounts realized on the sales for purposes of determining whether more than 25% of gross income was omitted so that the special six-year, rather than the normal three-year, limitations period applies (Barkett v. Commissioner, 143 T.C. No. 6).

The taxpayers filed their individual income tax returns for 2006 and 2007 on September 17, 2007, and October 2, 2008, respectively. The IRS on September 26, 2012 — more than three years after the returns were filed, but less than six years — sent a notice of deficiency determining income tax deficiencies for 2006 and 2007. The IRS asserted the taxpayers had omitted from their 2006 and 2007 returns amounts exceeding 25% of the gross income stated on their returns so that the six-year, rather than the normal three-year, limitations period applies.

The taxpayers on their 2006 and 2007 returns reported amounts realized from the sale of investments of more than $7 million and $4 million, respectively, and total gains from such sales of approximately $123,000 and $314,000, respectively. On filing a petition with the Tax Court, the taxpayers asserted that the amounts they realized — not their gains — were to be included in determining the 25% of gross income factor for purposes of determining whether the six-year statute of limitations should apply.

The Tax Court held that "gross income" includes only the gain from the sale of an investment, not the amount realized on that sale as it has held in other cases. Thus, the gross income that the taxpayers omitted was found to exceed 25% of the gross income that they had stated on their returns, so as to trigger the six-year statute of limitations.

First Circuit - Taxpayer Allowed Deduction for Compensatory Amounts Paid to Settle Civil Allegations

On August 13, the U.S. Court of Appeals for the First Circuit affirmed a decision of the federal district court that granted a tax refund exceeding $50 million to the taxpayer with respect to amounts that were found to be compensatory — and not punitive — damages paid by the taxpayer to settle civil actions brought by the government against the taxpayer pursuant to the False Claims Act (Fresenius Medical Care Holdings, Inc. v. United States, No. 13-2144 (1st Cir. August 13, 2014)).

The taxpayer operated dialysis centers in the United States and around the world. Between 1993 and 1997, whistleblowers brought a series of civil actions against the taxpayer under the False Claims Act (FCA). The government opened civil and criminal investigations into the taxpayer's federally funded health care programs. In 2000, the taxpayer entered into a complex of criminal plea and civil settlement agreements with the government. Under these agreements, the taxpayer was to pay over $486 million — of which, over $101 million was earmarked as criminal fines. The remaining $385 million was to absolve the taxpayer from civil liability.

It was agreed that the $101 million in criminal fines was not deductible, and that $192.5 million of the $385 million civil settlement agreement payment was deductible. The taxpayer and the government could not agree on the tax treatment of the balance of the civil settlement (a second amount of $192.5 million).

The taxpayer eventually initiated a tax refund action before the federal district court. A jury trial was held, and the jury found that $95 million of the $192.5 million in dispute was deductible—thus, resulting in a tax refund of $50 million.

The government appealed and the First Circuit affirmed. The First Circuit in a case of "first impression" held that in determining the tax treatment of a FCA civil settlement, a court may consider factors beyond the mere presences (or absence) of a tax characterization agreement between the government and the settling party.

Illinois: Governor Signs Legislation Revising Discriminatory Click-Through Nexus Statute

Legislation (Senate Bill 352) has been approved by Illinois' Governor Quinn that makes certain changes to the state's click-through nexus statute. Under this statute, which was enacted originally in 2011, a "retailer maintaining a place of business in Illinois" includes retailers that enter into contracts with in-state persons who, in exchange for consideration or commission, refer customers to the retailer by a link on the in-state person's Internet website, provided that total sales under all such agreements exceeded $10,000 per year.

The Illinois law, unlike nearly all other click-through statutes, provided no means for a remote retailer to rebut the presumption that the associate or affiliate relationships, standing alone, created nexus. In October 2013, the Supreme Court of Illinois held that the click-through law was void and unenforceable, as it constituted a discriminatory tax on electronic commerce, which is prohibited under the Internet Tax Freedom Act (ITFA).

Senate Bill 352 seems designed to fix the issues that create discrimination under the ITFA. Notably, the revised law provides that a "retailer maintaining a place of business in Illinois" includes retailers that contract with persons who, in exchange for consideration after a completed sale, refer potential customers to the retailer by providing the potential customers a promotional code or other mechanism that allows the retailer to track any purchases referred by such persons. Examples of mechanisms that allow the retailer to track purchases include, but are not limited to, use of a link on a person's website, use of codes delivered via hand-delivered or mailed material, or use of codes delivered though radio or broadcast media. In so doing, it appears the bill tries to cure the discrimination by capturing offline relationships with in-state persons as well as online relationships. The bill also adopts a rebuttable presumption that these relationships create nexus for out-of-state retailers. Senate Bill 352 did not include a specific effective date; thus, under Illinois law the bill is effective January 1, 2015.

Questions?

If you have any questions about this article please reach out to your KPMG engagement team or the contacts listed with this article.

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