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U.S. business update for Japanese companies

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Contents

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Rise of the Robots

"In the next 15 years, it's likely that 45 percent, and maybe up to 75 percent, of existing offshore jobs in the financial services sector will be performed by robots, or more precisely, robotic process automation (RPA)," stated Cliff Justice, KPMG LLP (KPMG) Advisory principal. "That should translate into enormous costs savings of up to 75 percent for firms that get on board."

And the potential benefits don't stop there. "Success in today's complex global financial markets requires unprecedented levels of speed, accuracy, and cost efficiency beyond what a human workforce can provide," observed Bill Cline, KPMG Advisory principal. "That's why firms in the financial services markets are increasingly turning to RPA and artificial intelligence (AI)-driven cognitive automation to transform their businesses."

As technology improves, robots will be able to do more sophisticated tasks faster and more efficiently than human workers. "Businesses that don't start taking steps now to integrate robotics and cognitive automation into their operations will not only find themselves at a huge disadvantage, they likely will be as obsolete as the employees that the robots have replaced," said Justice.

Powerful words... provocative predictions… In this paper, we take a look at what's behind these bold forecasts. We also explore some of the benefits that robots and AI/cognitive automation technology holds, including the ability to digest and analyze huge amounts of data. Finally, we present nine factors you should consider before implementing an RPA strategy. We strongly believe that robotic and cognitive automation is the wave of the future for global capital markets and financial services firms. It's crucial that you explore what you can do today to position yourself for success tomorrow.

For more information, download the full report below.

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Rise of the Robots > (PDF/3.5KB)

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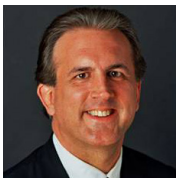

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The Creative CIO Leading technology from disruption to innovation

"CIOs and their IT organizations are at a crossroads where staying the course will most likely lead to marginalization as their business stakeholders turn elsewhere for technology solutions. The other road requires IT transformation to deliver the speed and agility their business users are demanding. This transformation requires IT to adopt new operating models; one where IT shifts its emphasis from building solutions to one that brokers solutions."

Marc Snyder, Managing Director, CIO Advisory, KPMG LLP

Foreword

There is no doubt that digital technologies are opening up new ways of relating to customers and new ways of doing business.

It is also true that, if organizations are to exploit technology to deliver real business value, they need to take brisk and purposeful action, because competition is fierce.

However, it needs to be the right action, in the right direction. This white paper offers some reassurance and practical advice that could help you, the CIO, steer your organization successfully (and reasonably serenely) through the rapids of technology innovation. The pace and impact of digital innovation can be unsettling. It appears that nothing is sacred, least of all traditional business models. However, while the potential is hugely exciting, it is not so much the technology itself, but what you do with it that matters.

That is exactly why we see an expanding role for the CIO who is prepared to be the evangelist for innovation in the C-suite. Creative CIOs are inspired by the potential opportunities of new technology, but also maintain a firm grip on the realities of the big business picture. They can balance and accommodate the demand for innovation, while keeping the wheels turning with existing customers and processes. It is these pragmatic champions of innovation who will drive the enterprise forward.

Tips for the Creative CIO

Contents

#1: Focus on your business

Stay focused on the needs of your business, your customers, and your people, and the impact of technology will be positive and decisive. The technology is exciting, but it is not an end in itself.

#2:Think it through

However urgent the need for change and innovation, it is vital to pause and identify your objectives and set out a road map for progress. Doing the right thing is the most important thing.

#3: Embrace your consumers

When you run IT like a business, users, partners, and customers are all consumers. Combining agile innovation with robust infrastructure will drive value throughout the business.

#4: Learn from examples

Make sure you know what your competitors are doing, but look more widely for examples of people who are making the most of technology through business-focused innovation.

#5: Invest in relevant digital skills

There is a severe shortage of people with the skills to deliver genuinely transformative innovations in technology. Whether you hire them or partner with them, you need them.

#6: Understand your strengths

Before you can create your innovation strategy, you need to understand how digitally savvy your organization is already. Knowing where you are helps make a case for where you want to go.

#7: Build the right relationships

Being a creative CIO is mainly about your impact on people, from C-suite colleagues and technology partners to your ultimate customers—both internal and external.

1. Focus on your business

There is one simple question that guides the application of innovative technologies: "What are we trying to achieve as an organization and how can technology help us achieve it?" If you stay focused on your business, your customers, and your people, the impact of technology will be positive and decisive. Of course, it is vital to be aware of what your competitors are doing and especially be vigilant for opportunist entrants to your market. But it is not enough to be a "me-too" player, because part of embracing technology innovation is about doing old things in new ways.

If the impetus for technology innovation focuses on business needs, this implies a new and influential role for the CIO in which the emphasis moves from 'systems provider' to 'enterprise enabler.' The only way to drive effective technology innovation is to understand where you are now, where you want to be and how you need to change. If you start creating digital products and services without an end plan, you are playing dice with the future and the odds are not in your favor. This is why CIOs need to play a lead role in the creation of a digital vision and technology road map for their businesses.

The companies that are genuinely exploiting the digital revolution are not rushing into mobile, cloud, social and analytics as passengers on the bandwagon. They are looking at the technology in the context of their own business, their customers, and colleagues— and then thinking, what could this do for us? What changes to our business and operating model can be better enabled by technology? Creative CIOs are building new relationships inside and outside the organization to make it happen.

2. Think it through

The media is full of stories about the "new industrial revolution," and companies are eager to sell you their particular version of the future. In this atmosphere, it is natural to feel that everyone else is surging ahead of you. But even the most advanced of the early adopters are still wrestling with the implications of digital innovation, from issues with tax, governance, and data security to shortages of talent. The truth is, it takes much longer to adopt new technologies than most people acknowledge.

"What I like about disruptive technology is that it cuts through the noise. It allows us to do things more creatively, more seamlessly, more independently and at higher value. But while the technology suggests great new ways of doing things, issues like security can dilute or neutralize that potential. Harmonizing these influences is the greatest challenge."

Harry Moseley, CIO,
KPMG LLP

When the whole world seems to be in the grip of a digital gold rush, it's difficult to take a step back and think. But that's what leaders need to do—especially the creative CIO. The more hysterical the clamor, the more important it is to come to your own decisions on the basis of your organization's own issues and priorities. This is why we believe the CIO remains such a central figure in the application of innovation: you alone have the cross- business perspective and technical grasp to align digital possibilities with business imperatives.

Of course, it is important to ask the right questions and engage fellow leaders in the journey. Nonetheless, the CIO is the obvious person to be the C-suite evangelist for technology innovation. That means getting a plan in place— mapping out a digital business agenda and designing a road map to deliver your objectives. And rather than reacting to pressure, you should set the pace. On page 6, we share a simple tool for assessing the "Digital Business Aptitude" of your organization; this is an excellent starting point for that journey.

"...the CIO is the obvious person to be the C-suite evangelist for technology innovation"

3. Embrace your consumers

As people on the front line have come to expect more of technology, the relationship between IT and business users has shifted. If there's a problem to solve, you can buy solutions directly from external providers. What started with Bring Your Own Device (BYOD) to work is already evolving into Bring Your Own Software (BYOS). However, as the IT function wants to check the security and quality of any new node on their network, they can easily be written off as enemies of progress. If IT always spells NO, the landscape is likely to become increasingly lawless and chaotic.

With a creative CIO, however, IT can play a proactive role in reaching the full potential of technology to transform the capability of the business. The threats and the risks associated with security, compliance and access haven't gone away, but the true visionaries have changed their position from risk avoidance to risk management. With that shift, it is possible to create a workforce that is hugely more efficient, and capable of providing an enhanced experience to both customers and employees.

Creative CIOs run IT functions like businesses, embracing consumerization and driving value throughout the organization. The CIO has the insight and overview to create a new landscape that combines high-speed, agile innovation with secure, robust, and scalable infrastructure. Rather than fighting to keep up with the competition, you could be setting the agenda for digital evolution and managing the various components, assets, and relationships that make it all happen.

"It's time to treat your workforce as your customer. We need to create experiences that solve their problems. And it's more important to solve small problems really well, rather than provide mediocre solutions to the big ones. But we also want to keep joining the dots between the technologies we deploy and the impact we can have on the business…"

Dave Wolf, Managing Director, Digital and Mobile Solutions, KPMG LLP

4. Learn from examples

Technology innovation drives increased sales and revenue at Trane

Because "digital disruption" is such a hot topic, it is easy to assume that technology is only going to apply to cool new industries with switched-on customers and employees. In fact, the most interesting and profitable business transformations focus on very traditional virtues – such as convenience, choice, speed, and value. Whatever your business is set up to do, there is a strong possibility that digital technology could help you do it better.

Understanding the business context

Trane sells premium HVAC systems in residential and industrial markets. In recent years, growth has been sluggish on the residential side, and it became clear that the problem was right at the interface with customers —with the dealer network. Dealers were conveying inconsistent messages about the company and its products, and customer service standards did not live up to the quality of the products either.

Linking relationships to technology

With help from digital and mobile specialist Cynergy Systems (acquired by KPMG LLP in March 2014), Trane took the time to understand its challenges in detail by carefully profiling dealer behaviors and motivations, they could apply the processing power of digital technology to a deep understanding of the human relationships at the heart of every sale.

Innovation that focuses on the customer

The resulting solution makes technology the servant of the customer experience. Trane MAP is an iPad-based application that dealers take on home visits. The system leads the salesperson through a consistent guided sales process, collecting information about the customer's home, and identifying the best product package for their house. The system generates an interactive presentation explaining what Trane offers as a company and why the recommended solution is right for that customer. The transaction is personal and immediate: customers see a fully-costed proposal tailored specifically to their home; and because they can sign up immediately, many more do.

5. Invest in relevant digital skills

Is technology innovation more difficult for established, larger companies than smaller start-ups? You might think that big businesses would have a lot more invested in the kind of legacy infrastructures that reduce agility and hamper innovation. The reality is more complex.

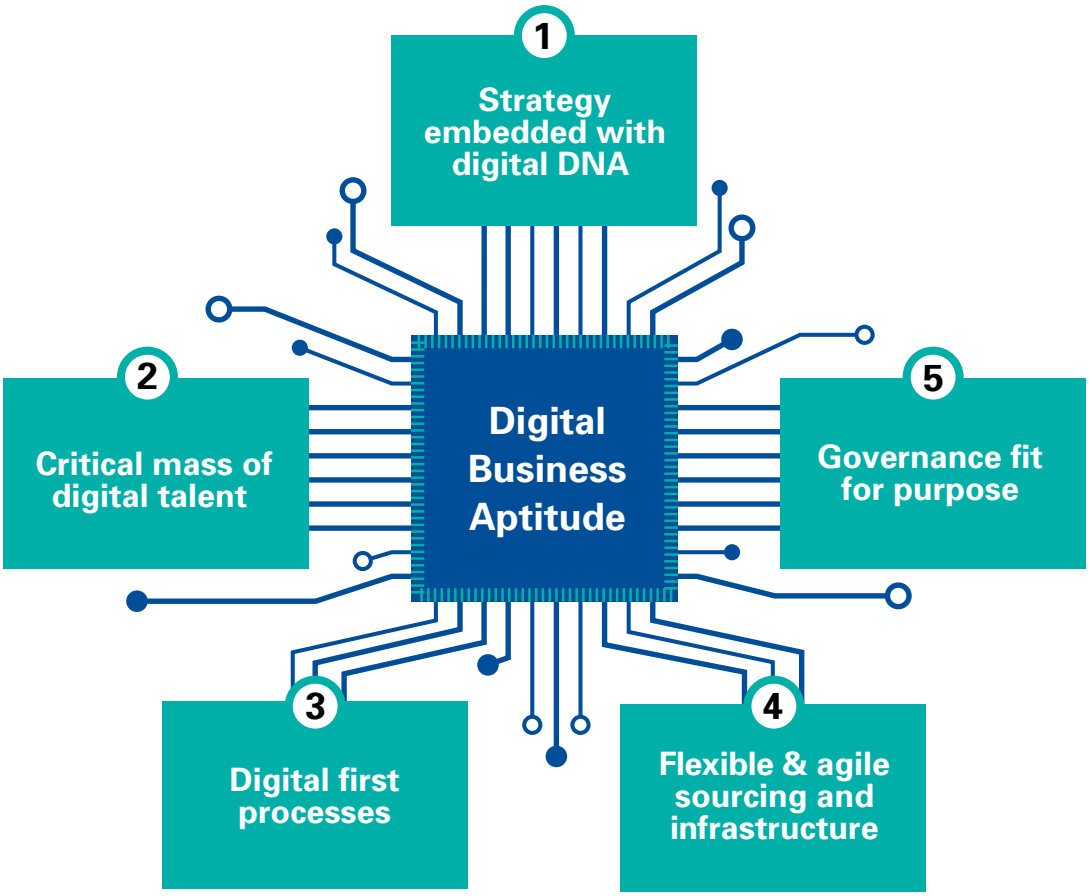
It is true that venture companies like Uber can arrive out of nowhere, with astonishing capability, because digital technologies like cloud lower the barriers to entry. However, bigger players may find it easier to invest the time and resources to rethink their relationships with customers, colleagues, and suppliers. The technology and trends that create such exciting opportunities for entrepreneurs also put radical change within the grasp of established enterprises.

One thing is certainly true for all: there is a severe shortage of people who can conceive, design, and build genuinely transformative digital solutions. This implies a need to build digital skills in-house, while also exploring new partnerships with expert and specialist providers in the external market. Some firms have even pursued small acquisitions primarily for their digital talent. For many technology innovators, the turning point has been the funding of an in-house R&D capability: this puts innovation at the top of the agenda and also allows people to 'get their hands dirty' building prototypes and trying out new ideas in a laboratory environment.

This is why a road map for technology innovation can be such a powerful tool: bluntly, if you have a clear understanding of the big picture, you can afford to test new ideas, see what works, and then do more of it. Whether you call it prototyping, wedge innovation, proof of concept, or fail-fast, "trying stuff out" is a great way to innovate because reality is the best test-bed. "Freedom to fail" can trigger remarkable innovations, as long as everyone understands the approach and subscribes to the same.

6. Understand your strengths

We have identified **five key capabilities** that characterize successful technology innovators. You can use these indicators as a diagnostic framework to assess how "digitally savvy" your organization is right now and what you might want to do about it.



Assessing your digital business aptitude (DBA)

[1] Strategy embedded with digital DNA

Because of digital disruption's profound impact on markets, products, services, and business models, successful organizations don't have a digital strategy layered on top of their enterprise strategy. Instead, they are often one and the same. The digital strategy is implicit and embedded within the enterprise strategy.

[2] Critical mass of digital talent

Digital talent is extremely scarce, so companies need to look at new ways of sourcing and deploying expertise. These can range from strategic partnerships and targeted 2. acquisitions to developing mixed talent pools that integrate internal and external expertise. It may be possible to enhance existing talent by concentrating skills in centers of excellence and digital acceleration teams. A digital business road map will make it easier to identify and fill talent gaps.

[3] Digital first processes

Competing successfully as a digital business creates new challenges and expectations. The IT organization can expect to face increasing complexity and the rapid assimilation of new technologies, while managing new risks and operating at a much faster cadence—especially in developing and delivering solutions. User-centric design, flexible and agile development, frequent deployments, and analytics-driven quality assurance processes are indicative of a digital-first approach.

[4] Flexible and agile sourcing and infrastructure

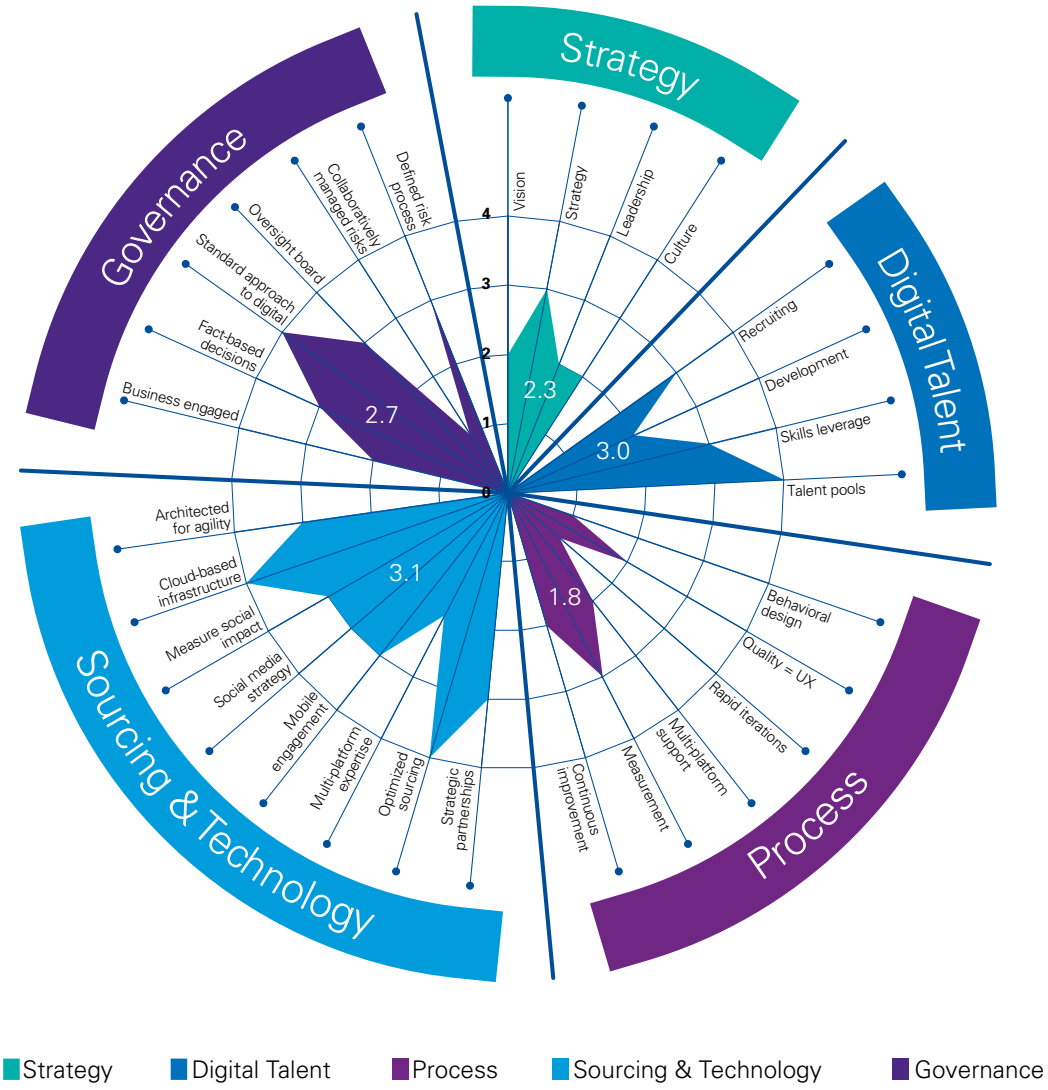
Conventional infrastructure may be inflexible, complex, and limited in capacity. While cloud offers an obvious solution to these issues, new platforms must be secure enough to protect against cyber attacks, resilient enough to support 24/7 operations, and agile enough to accommodate a huge swing in demand while supporting automated provisioning.

[5] Governance fit for purpose

There is an inherent conflict between the need for speed and the requirement for appropriate controls. Success depends on moving away from extreme risk avoidance towards a more fluid governance process that manages risk while devolving both decision-making and accountability to the point of impact.

The DBA assessment

The DBA assessment provides a practical, real-world indicator of digital maturity; you can use it as a simple self-assessment tool that highlights priorities for change as a business prepares itself for digital evolution. You don't have to score the maximum on every capability to succeed; however, consistently low scores indicate areas of vulnerability that might need attention.



Strategy Digital Talent Process Sourcing & Technology Governance

7. Build the right relationships

In the past, significant innovations in technology came along one at a time and the journey was simple and linear. Today we are in a world where four or five big things have arrived together, with more close behind them. From cloud and mobile to analytics and social, each of these advances has the potential to produce enormous value in its own right; however, the full potential emerges only when those capabilities work in combination to create new experiences for consumers and colleagues.

While the big leaps forward may be empowered by advances in technology, success depends on a new level of engagement and consensus among stakeholders across the entire organization. The business case for genuinely innovative investment will look different from the "sustaining investment" that merely keeps the lights on. The stakes are higher and the ROI may be less certain or longer in coming. Although we see great potential for the CIO to perform the role of "enterprise enabler," it may be necessary to build new kinds of relationships with experts in the digital landscape. It will require a new operating model and sourcing strategy. IT organizations can no longer afford to go it alone as single source providers of technology solutions. They will build new kinds of relationships ranging from experts in the digital landscape to acquire needed skills, cloud-based infrastructure, and service-based solutions.

For example, the KPMG's Digital and Mobile Solutions team that worked on the Trane MAP project (see page 7) is one of the world's leading customer experience agencies: it is also part of KPMG's digital enablement capability that provides full-cycle support to CIOs and their teams. We can help you understand the kind of talent you need to hire and how to structure a team that thinks digitally; we can help frame approaches to product research, design, and management, from concept to roll-out; we also provide the wider business advisory expertise that grounds digital strategy in the real world. This re-positions the IT team as the go-to partner for solution delivery and management.

"There are plenty of agencies who can build beautiful apps and thereare plenty of folks who want to help you organize your IT, but it feels like mixing the two is oil and water. You need a provider who sees both sides of the coin and we bring both types of capability: that means you get practical, value-adding innovation that supports the big business picture..."

Joel Osman,
Managing Director,
Digital and Mobile Solutions,
KPMG LLP

In conclusion

This white paper has shared seven tips for success in digital innovation and highlighted a role for a new breed of creative CIO. We know that some of this may seem easier said than done, especially as some companies are more digitally ready than others. However, these tips are grounded in fundamental business principles and intuitive common sense. It is no coincidence either, that the culminating point is about relationships: there are plenty of people, inside and outside your organization, who will be interested in and inspired to help with the journey of digital innovation.

#1: **Focus on your business**

#2: **Think it through**

#3: **Embrace your consumers**

#4: **Learn from examples**

#5: **Invest in relevant digital skills**

#6: **Understand your strengths**

#7: **Build the right relationships**

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Section 385 Final Regulations: Initial Reactions

On October 13, The Treasury Department and IRS late yesterday released final and temporary section 385 regulations (hereinafter the "Final 385 Regulations") addressing the treatment of related party debt for U.S. tax purposes. These regulations had been proposed on April 4, 2016 (the "Proposed 385 Regulations").

The final rules offer significant relief for U.S. multinational groups, and offer some, but less significant, relief for foreign multinational groups.

The discussion below contains a high-level summary of the section 385 regulations, including the key changes from the Proposed 385 Regulations, based upon KPMG's initial review of the new rules, and will be supplemented with further analysis in the future.

Structure

As with the Proposed 385 Regulations, the final version contains four separate sections: Treas. Reg. §§ 1.385-1 (providing general definitions and rules); 1.385-2 (the "Documentation Rules"); 1.385-3 (the "Recast Rules"); 1.385-4 (the "U.S. Consolidated Group Rules"). Certain matters within the rules are reserved.

Effective dates

Under the Proposed 385 Regulations, the Documentation Rules were effective for debt issued on or after the date the regulations became final. The Recast Rules were technically applicable to debt issued on or after April 4, 2016, and to "tainted" transactions occurring on or after that same date, subject to a 90-day grace period upon finalization before affected debt instruments are deemed converted into equity.

The Final 385 Regulations offer significant relief with respect to the final Documentation Rules' effective date in two main ways. First, the final Documentation Rules only apply to debt issued on or after January 1, 2018, and to debt issued after that date pursuant to an "overall arrangement" in effect prior to that date. Second, the documentation requirements now are only required to be completed as of the filing of the tax return (including extensions) for the taxable year in which the "relevant date" occurs, rather than by the "relevant date." Together, these extensions provide companies an additional year of time to better assess their current status, update their systems and develop the necessary procedures to implement the documentation rules.

The effective date for the Recast Rules was largely retained, and thus applies to transactions occurring and debt issued on or after April 4, 2016. There is also a complicated "final transition period" that generally exempts debt from the Recast Rules if it is settled within 90 days of the publication of the Final Regulations (estimated to occur on October 21). Any debt that would have been recast between April 4, 2016 and the end of the final transition period is subject to recast upon the end of the final transition period.

Foreign Issuer Exception

Arguably the Proposed 385 Regulations were overbroad in that they contained no U.S. tax "relevancy" filter to their application. Thus, for example, if a U.S. company was considering acquiring the stock of a foreign target that had no U.S. tax connection, the U.S. company would have to evaluate and reconstruct the foreign target group's intercompany transactions through the lens of the Proposed 385 Regulations which necessarily were not considered by the target company at the time.

Treasury and the IRS also had repeatedly noted that they would provide for a "foreign to foreign" or "relevancy" exception, which was expected to exclude at the least debt issued between two foreign entities that did not have U.S. tax relevance. Some commentators also requested treating all of an expanded group's "controlled foreign corporations" as a single corporation for purposes of the 385 rules, in order to minimize the rules' application to transactions that were not directly U.S.-tax relevant.

The Final 385 Regulations broadly exempt all debt issued by foreign corporations, including both controlled foreign corporations ("CFC"s) and non-U.S. controlled foreign corporations. The change is implemented by limiting the current application of the rules to debt issued by a "covered member," meaning a member of the expanded group that is a domestic corporation. The significance of this carveback cannot be overstated, particularly for U.S. multinationals. The restricted definition also exempts debt issued by partnerships from the scope of the Documentation Rules, although debt of a covered member that is held by a controlled partnership is still subject to the rules.

Cash pooling

Perhaps the most commented-upon and discussed issue for the Proposed 385 Regulations was how they would apply in the context of "cash pooling" arrangements, a modern treasury function used by many multinationals to streamline groups' interaction with external lenders and also to facilitate intercompany financing. Treasury and the IRS have indicated that they did not intend to generally deny multinationals the ability to use cash pooling arrangements, but wanted to ensure that the arrangements could not be used to avoid the substance of the Proposed 385 Regulations.

The general exemption for foreign issuers should provide significant relief in this regard. For domestic issuers, the Final 385 Regulations also provide more detail regarding how to satisfy the four requirements in the Documentation Rules with respect to cash pooling arrangements (discussed further below). More broadly, however, the Final 385 Regulations do not provide a holistic definition of a cash pooling arrangement for U.S. income tax purposes, and do not exempt cash pooling arrangements (including notional cash pooling arrangements) from the Documentation Rules. In the context of the Recast Rules, certain demand deposits made by group members are not subject to recharacterization.

Bifurcation

In a significant change from the Proposed 385 Regulations, Treasury and IRS did not include the much-discussed and ambiguous "Bifurcation" rule in the Final 385 Regulations. The Bifurcation rule would have provided the IRS, upon audit, the authority to determine that an instrument that was treated as debt by the taxpayer should instead be treated as part-debt and part-equity, for example because the issuer could only reasonably be expected to service less than 100% of the debt obligations. Numerous commentators focused on the lack of specificity and guidance around the rule and questioned how it would be applied in practice by revenue agents.

The changed position means that under the Final 385 Regulations, the debt versus equity classification for U.S. tax purposes generally remains an "all-or-nothing" determination. The preamble to the final regulations indicate that Treasury and the IRS continue to study this issue, but because it was not included in the final regulations, the preamble does not discuss the comments received with respect to the Bifurcation rule.

S Corporation status

A significant collateral effect of the Proposed 385 Regulations would have been that if debt issued by an "S Corporation" were recharacterized into equity, the deemed equity could invalidate the S Corporation's "S Election" by being treated as a prohibited second class of stock. The Final 385 Regulations responded to comments requesting relief on this point by excluding S Corporations from the definition of an expanded group, thereby fully exempting debt issued by S Corporations from the section 385 rules.

Application to Regulated Financial Institutions, Insurance Companies, RICs and REITs

The Proposed 385 Regulations did not contain an explicit carveout for debt issued by corporations that are subject to regulatory oversight (such as financial institutions and insurance companies) and thus have limited ability to "manipulate" their debt issuances, or that are effectively pass-throughs under special U.S. tax regimes and thus have limited incentive to engage in "earnings stripping."

The Final 385 Regulations exclude RICs and REITs from being members of an expanded group, and thus debt issued by such entities is outside the rules, unless the RIC or REIT is controlled by members of an otherwise existing expanded group.

For regulated entities, the Final 385 Regulations do not provide any exception from the Documentation Rules for debt issued by such companies. The final Recast Rules, however, do not apply to debt issued by qualifying "regulated financial companies" and certain other specified non-financial companies, including insurance companies.

Application to debt issued by DREs and partnerships

The Proposed 385 Regulations treated debt issued by disregarded entities ("DRE"s) and partnerships differently for purposes of the proposed Documentation Rules and Recast Rules. Under Prop. Reg. § 1.385-2, the Documentation Rules were applied at the level of the legal entity issuing the debt—i.e., the DRE or partnership (provided the partnership was considered an Expanded Group member). Debt that failed to satisfy the Documentation Rules and was recast into equity could therefore result in such entities having new members for U.S. tax purposes, with potentially retroactive effect. By contrast, under Prop. Reg. § 1.385-3, the Recast Rules applied an aggregate or "look-through" approach to debt issued by pass-through entities, which was tiered up to the DRE's corporate owner or the partnership's corporate partners, as applicable.

Numerous commentators criticized and questioned the applicability of the Proposed 385 Regulations to debt issued by partnerships because of the statutory language providing that Section 385 operates to determine whether an interest "in a corporation is to be treated…as stock or indebtedness…".

In response, the Final 385 Regulations now exclude debt issued by partnerships from the Documentation Rules. This is implemented by applying the Documentation Rules only to debt issued by "covered members," meaning members of the expanded group that are domestic corporations. Debt issued by DREs of covered members is subject to the Documentation Rules, but if such debt is recast it is converted into equity of the DRE's regarded owner (that is, the covered member) and not into equity of the DRE. This change will reduce the uncertainty and burden that would have existed if debt "flunking" the Documentation Rules could result in new partners being deemed to exist in partnerships or DREs being deemed to convert into partnerships. The final Recast Rules continue to generally apply the aggregate model to debt issued by or to a partnership that has partners that are members of an expanded group, with some modifications. The Recast Rules also apply to debt issued by a DRE, but again treat the holder of the recast debt as owning deemed equity in the DRE's regarded owner and not in the DRE.

Significant changes to the Documentation Rules

1. Clarified Scope and Process

As under the Proposed 385 Regulations, the substantive documentation requirements are: (i) a sum certain; (ii) creditor's rights; (iii) the borrower's ability to repay; and (iv) go-forward compliance with the terms of the debt instrument, such as evidence of timely payments and what enforcement actions were taken if an event of default occurs.

The Proposed 385 Regulations were drafted very broadly, by their literal terms applying to all expanded group debt (once the de minimis thresholds were crossed) irrespective of the size, duration or nature of the debt instrument. The only exception in this regard was that the Prop. Reg. § 1.385-3 recast rules contained a limited "ordinary course" exception for some trade payables. In response, numerous commentators requested that the ordinary course exception be broadened in scope and made applicable to the § 1.385-2 documentation rules; and also that some kind of overarching short-term and/or de minimis loan exception be provided.

For the Documentation Rules, Treasury and the IRS declined to provide these types of definitional exceptions. Instead, the Final 385 Regulations generally apply to all types of "in-form" debt for U.S. federal income tax purposes, now including specifically debt that is evidenced only through journal entries, in trade accounts, or another accounting system that does not generally form part of a company's long-term liabilities from an accounting perspective and is not corroborated by a separate legal agreement. The rules continue to reserve on the application of the Documentation Rules to debt that is not debt "in form," such as debt arising under a substance-over-form analysis of a "sale and repurchase" or "repo" transaction.

The Final 385 Regulations, however, provide a more feasible overall approach to satisfying the Documentation Rules. The proposed Documentation Rules raised the possibility that the expanded group would have to produce a new loan document for every accounting entry, even multiple times over the course of the same day for the same entity, and similarly to have to comply with the ability-to-pay analysis in a redundant fashion. The final Documentation Rules provide more detail on how taxpayers can use "umbrella" or "master" credit agreements that can serve as the documentation "platform" from a creditor's rights and sum certain perspective for cash pooling, open credit facility, and similar high-volume intercompany financing arrangements.

In this regard, the final rules provide that if a transaction is not evidenced by a separate note or other written documentation, the sum certain and creditor's rights requirements can be met only if material documentation, including enabling documents, are prepared and maintained pursuant to the overall agreement. Enabling documents are defined as including "board of directors' resolutions, credit agreements, omnibus agreements, security agreements, or agreements prepared in connection with the execution of the legal documents governing the EGI as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI."

Regarding the ability-to-pay analysis, the final rules helpfully permit taxpayers using such an "overall arrangement" to only perform the analysis on an annual basis, unless a specified "material event" occurs (which triggers a new analysis requirement). This annual analysis must contain information establishing that as of the date of the annual credit analysis, taking into account all relevant circumstances (such as other obligations incurred by the issuer or reasonably anticipated to be incurred after the analysis date), "the issuer's financial position supported a reasonable expectation that the issuer would be able to pay interest and principal in respect of the maximum principal amount permitted" under the terms of the agreement.

Between the new exception for foreign issuers (discussed above) and the continued treatment of U.S. consolidated groups as one taxpayer, the universe of debt instruments to which the final Documentation Rules apply is significantly narrower. While still potentially creating a compliance burden for U.S. issuers, these changes should lessen the concern that vast amounts of redundant documentation would be required.

2. Exceptions to Recast Effect

Under the Proposed 385 Regulations, failure to satisfy the Documentation Rules automatically recast the instrument into stock. Commentators noted that this could be inappropriate, especially when the relationship otherwise bore the common law factors supporting debt treatment. The final Documentation Rules adopt these suggestions by permitting taxpayers that are "highly compliant" with the rules to rebut in some cases the presumption that the documentation failure results in equity recharacterization.

The Final 385 Regulations also retain the "reasonable cause" exception for curing a missed documentation requirement.

3. Final Status of Documentation Rules

In summary, the Final 385 Regulations require documentation for all "in form" debt issued by U.S. corporations (that are members of an expanded group) to expanded group members outside of the issuer's U.S. consolidated group.

The Final 385 Regulations retain the proposed "relevant date" concept of 30 days or 120 days after the debt issuance or creditor event. In a crucial change, however, the substantive documentation now must only be completed by the due date for filing (including extensions) the tax return for the taxable year that the "relevant date" falls within, and thus no longer by the relevant date itself. Thus, the "relevant date" now serves as the marker to associate the event with a particular year's tax return and is not itself an effective date or applicability date.

This change will provide companies significantly more time to satisfy the Documentation Rules. Furthermore, the delay in effective date for the final Documentation Rules—to debt issued on or after January 1, 2018—provides a helpful transition period for companies to develop the necessary systems and agreements to comply going forward. Thus, for calendar-year taxpayers that file an automatic return extension, their first round of documentation materials will not be technically "due" until late 2019.

Significant changes to the Recast rules

1. No Change to 72-Month Per Se Period

Perhaps the most controversial aspect of the Proposed 385 Regulations was the per se "funding rule," which provided that any debt instrument issued within 36 months before or after a taxpayer's implementation of a "tainted" transaction (generally, a distribution to shareholders; acquiring an EG member in an asset reorganization with "boot"; and acquiring stock of another EG member in exchange for property) would be recharacterized to the extent of the amount of the transaction. Although styled a "principal purpose" rule, the 36 month before-and-after per se periods permitted no exception to the funding rule's application. Government officials have defended the provision because of the chronic underfunding and resource constraints of the IRS made it impractical to take a more nuanced approach to the issue. A bright-line test can be administered by the IRS without needing to consider the subjective facts and circumstances.

The Final 385 Regulations contain the 72-Month rule and the inability to rebut the presumption of a principal purpose for debt issued within that period. As discussed elsewhere herein, however, the narrower scope of the final rules should reduce the number of loans that must be monitored for purposes of the Recast Rules.

2. Expanded Exceptions to In-Scope Debt

The Proposed 385 Regulations contained an "ordinary course" exception to the Funding Rule for certain intercompany trade payables arising in connection with the purchase of property or the receipt of services. Otherwise, any instrument treated as debt for U.S. tax purposes generally could be caught.

Helpfully, the Final 385 Regulations contain several new categories loans that are exempt from the Funding Rule, including:

a. Demand deposits placed with the "qualified cash pool header" entity pursuant to a "cash management arrangement";

b. One of two alternative "short-term" funding arrangements, respectively based on the current assets arising from ordinary course transactions and as reported on the issuer's financial statements in the current period or certain loans outstanding for 270 days or fewer;

c. Loans issued for property (other than cash) in the ordinary course of the issuer's trade or business, provided reasonably expected to be repaid within 120 days; and

d. Loans which are interest-free in fact and which are not required to carry interest under the applicable U.S. tax rules—e.g., they do not have OID, are not required to impute interest under sections 483 or 7872, and are exempt from bearing an arm's-length interest rate under section 482.

3. Current Year E&P Exception

Under the proposed regulations, the Recast Rule and Funding Rule in Prop. Reg. § 1.385-3 would not apply to the extent of the corporations' current-year earning and profits ("E&P"). The exception, which was intended to approximate exempting a distribution by companies' of their customary annual profits, was a widely-discussed topic. At times government officials have suggested that a different metric (such as a three-year rolling average for current E&P) might be included instead because of, e.g., the narrow and somewhat elective nature of the current E&P measurement.

The Final 385 Regulations retain and expand the current E&P exception in two significant ways. First, the new exception permits all E&P that accumulate in years ending after the initial proposal to be included in the "buffer" that prevents recharacterization of debt instruments under the Recast Rules. This change is implemented through the new concept of a member's "expanded group earnings account," which includes earnings accumulated by the member in taxable years ending after April 4, 2016 (and importantly, excluding dividends attributable to pre-effective date years' E&P). Second, the new exception permits taxpayers to net "qualified contributions" of non-excluded property into a subsidiary against distributions and stock purchases by the subsidiary, with the effect that only debt equal to the "net reduction" of the subsidiary's capital amount is subject to recharacterization.

Because the Recast and Funding rules were technically retroactive to April 4, 2016, a question of reliance arises for taxpayers that may have expected to use the current year E&P exception in their transactions and planning decisions during the interim period. The final regulations include a transition rule under which taxpayers may choose to apply the proposed versions of §§ 1.385-1, -3 and -4 to debt issued on or after April 4, 2016, and before October 13, 2016, provided that approach is consistent.

4. Clarification of Potential "Cascading" Recasts

Another thorny aspect of the proposed Funding Rule was that it appeared possible for a single distribution or acquisition transaction to eventually taint numerous intercompany loans. For example, if a dividend by Company A were to recast a loan taken out by Company A as equity, and then repayment of that recast loan created a new dividend-equivalent redemption of the deemed stock, another dividend distribution would arise which could potentially taint other expanded group borrowings by Company A, and so on.

In response to numerous comments to limit and clarify the application of the funding rule on this matter, Treasury helpfully modified the application of the funding rule to somewhat prevent this "cascading" effect. Under the final regulations, once a debt instrument (e.g., Debt A) has been recast into equity under the Funding Rule, the "tainting" transaction no longer can recast other debt instruments even after Debt A is repaid. The government did not agree, however, that a repayment of Debt A that was treated as a dividend-equivalent redemption should also be excluded as a new dividend for purposes of the funding rule, and thus that deemed dividend can still recast other in-scope debt.

Collateral effects upon other Federal Income Tax Provisions

The effect of recasting debt into equity for U.S. tax purposes raises a host of collateral issues for the conversion and repayment of such instruments, including the section 902 foreign tax credit treatment of repayments of recast debt and the status of recast debt for ownership provisions such as in the corporate reorganization and non-recognition rules, "S-Corporation" eligibility, consolidated group ownership rules, and for purposes of U.S. income tax treaties.

A number of these concerns have been significantly ameliorated by the reduced scope of the Final 385 Regulations and their sole application to debt issued by domestic C-corporations. Thus, for example, debt issued by a CFC could not be treated as non-voting stock with adverse section 902 implications; debt issued by foreign entities "above" a domestic corporation in the ownership chain cannot be recast into equity in a way that would muddle Treaty ownership requirements; and debt issued by S Corporations cannot be converted into a second class of stock that threatens the Subchapter S Election's viability.

For the debt that remains in scope, however, Treasury and the IRS rejected the requests by commentators to carve back the recast effect for purposes of any other provision, except for one relating to affiliated group status. The sole exception is that debt recharacterized under the Recast Rules is, if not described in section 1504(a)(4) (generally, "plain vanilla" preferred that is not treated as stock for purposes of the affiliated group test) and excluded under that provision, then nevertheless not treated as stock for purposes of section 1504(a). This exception will help limit the risk that recast debt would "de-consolidate" the U.S. corporate issuer.

Conclusion

The proposed rules have been characterized as one of the most significant changes, and potentially burdensome new regimes, in the U.S. international tax system in decades. After much speculation and concern, the final product reflects a significant effort by Treasury and the IRS to limit the scope and burden of the 385 Regulations, particularly for U.S. multinationals. The Final 385 Regulations contain many new terms and concepts that bear further close scrutiny, and they will be addressed in subsequent reports.

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Questions?
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Jnet newsletter

U.S. business update for Japanese companies

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 Changes Presentation of Not-for-Profit Financial Statements

Defining Issues 16-29 reports that a new FASB ASU changes how not-for-profit (NFP) entities, including health care entities, report net asset classes, expenses, and liquidity in their financial statements. The FASB deferred to Phase 2 of its project on NFP financial statements the decision about requiring a measure of operations in the statement of activities.

Go to Defining Issues 16-29 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-29-fasb-nfp-financial-statments.pdf

Companies Face New Rules on Extraction Industry Payments

Defining Issues 16-30 reports that resource extraction companies will need to disclose payments, or a series of payments, over $100,000 made to governments related to the exploration and development of oil, natural gas, or mineral resources. However, the SEC's final rules provide some relief to address concerns.

Go to Defining Issues 16-30 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-30-sec-extraction-payments.pdf

FASB Proposes Targeted Changes to Hedge Accounting

Defining Issues 16-31 reports that the FASB's proposed ASU would provide additional opportunities for an entity to align its hedge accounting with its risk management activities, and has the potential to reduce the cost and effort required to apply hedge accounting.

Go to Defining Issues 16-31 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-31-hedge-accounting.pdf

EITF Reaches Final Consensus; SEC Staff Discusses Recent Accounting Standards

Defining Issues 16-32 reports that the FASB's Emerging Issues Task Force (EITF) reached a final consensus on the presentation of restricted cash in the statement of cash flows and a consensus-for-exposure on service concession arrangements at its September 22 meeting. Also, the SEC staff discussed its expectation that registrants will disclose their implementation status and, if determined, the likely qualitative effect of recently issued accounting standards.

Go to Defining Issues 16-32 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-32-eitf.pdf

FASB Decides to Retain Guidance on Pre-production Costs

Defining Issues 16-33 reports that the FASB decided to retain the current guidance on capitalization of pre-production costs related to long-term supply arrangements while it conducts outreach to decide whether it should propose additional changes. The FASB also did not want to delay issuing its technical corrections for the revenue standard, most of which did not pertain to pre-production costs.

Go to Defining Issues 16-33 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-33-preproduction-costs.pdf

FASB Changes Accounting for Income Taxes on Intercompany Transfers

Defining Issues 16-34 reports that, as part of its simplification initiative, the FASB recently issued an ASU that requires entities to recognize at the transaction date the income tax consequences of many intercompany asset transfers.

Go to Defining Issues 16-34 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-34-income-tax-intercompany.pdf

FASB Makes Targeted Change to VIE Primary Beneficiary Test

Defining Issues 16-35 reports that in evaluating whether it is the primary beneficiary, the new FASB ASU requires a single decision maker or service provider to consider indirect interests held through related parties under common control proportionately.

Go to Defining Issues 16-35 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-35-common-control.pdf

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Jnet newsletter

U.S. business update for Japanese companies

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 2016

Notice 2016-62: Pension plans, cost-of-living adjustments for 2017

On October 27, the IRS released an advance version of Notice 2016-62 providing the dollar limitations for qualified retirement plans for tax year 2017.

Changes for 2017

Notice 2016-62 [PDF 25 KB] and a related IRS release—IR-2016-141 (October 27, 2016)—note the following changes in amounts from 2016 to 2017.

- For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $186,000 and $196,000 (up from $184,000 and $194,000).
- The AGI phase-out range for taxpayers making contributions to a Roth IRA for married couples filing jointly is $186,000 to $196,000 (up from $184,000 to $194,000). For single taxpayers and heads of household, the income phase-out range is $118,000 to $133,000 (up from $117,000 to $132,000).
- The AGI limit for the saver's credit—also known as the retirement savings contribution credit—for low- and moderate-income workers is $62,000 for married couples filing jointly (up from $61,500); $46,500 for heads of household (up from $46,125); and $31,000 for married individuals filing separately and for singles (up from $30,750).
- The deduction for taxpayers making contributions to a traditional IRA is phased out for those who have modified adjusted gross incomes (AGI) within a certain range. For single taxpayers who are covered by a workplace retirement plan, the income phase-out range is increased to $62,000 to $72,000 (up from $61,000 to $71,000). For married couples filing jointly, when the spouse who makes the IRA contribution is covered by a workplace retirement plan, the income phase-out range is increased to $99,000 to $119,000 (up from $98,000 to $118,000). For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

401(k) amounts

The limitations that remain unchanged from 2016 include the following:

- The elective deferral (contribution) limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains unchanged at $18,000.
- The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains unchanged at $6,000.
- The limit on annual contributions to an Individual Retirement Arrangement (IRA) remains unchanged at $5,500. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.
- The AGI phase-out range for a married individual filing a separate return who makes contributions to a Roth IRA is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

FASB: Accounting changes for income taxes on intercompany transfers

The FASB, as part of its simplification initiative, issued an Accounting Standards Update that requires entities to recognize at the transaction date the income tax consequences of many intercompany asset transfers.

Rev. Proc. 2016-55: Inflation adjustments for 2017

On October 25, the IRS released an advance version of Rev. Proc. 2016-55 that provides the annual inflation adjustments for more than 50 tax provisions, including the tax rate schedules and other tax amounts as adjusted for inflation for 2017.

Rev. Proc. 2016-55 [PDF 101 KB] provides details about these annual adjustments. The tax year 2017 adjustments generally are used on tax returns filed in 2018.

Certain individual income tax amounts increase, others unchanged for 2017

As briefly explained in a related IRS release—IR 2016-139 (October 25, 2016)—the following items reflect the inflation adjustments for 2017:

Standard deduction

Taxpayers	2017 amount	Compared to 2016 amount
Married filing jointly	$12,700	Up from $12,600
Single / married filing separately	$ 6,350	Up from $6,300
Heads of households	$ 9,350	Up from $9,300

Personal exemption: No change for 2017—$4,050

Personal exemption phase-out:

- Personal exemption phase-out begins with adjusted gross income (AGI) of $261,500 ($313,800 for married filing jointly).
- Personal exemption phases out completely at AGI of $384,000 ($436,300 for married filing jointly).

39.6% income tax rate: For tax year 2017, the 39.6% tax rate applies for:

- Single taxpayers whose income exceeds $418,400 (up from $415,050 in 2016)
- Married taxpayers filing jointly whose income exceeds $470,700 (up from $466,950 in 2016)

Itemized deduction limits

- The limitation for itemized deductions to be claimed on tax year 2017 returns of single taxpayers begins with incomes of $261,500 or more ($313,800 for married filing jointly).

AMT exemption

- The alternative minimum tax (AMT) exemption amount for tax year 2017 is increased to $54,300 for single taxpayers ($84,500 for married filing jointly). The 2016 exemption amount was $53,900 ($83,800 for married filing jointly).
- The AMT exemption begins to phase out for single taxpayers at $120,700 ($160,900 for married filing jointly).

Foreign earned income exclusion

For tax year 2017, the foreign earned income exclusion is $102,100 (up from $101,300 for tax year 2016)

Earned income credit (EIC)

The tax year 2017 maximum EIC amount is $6,318 for taxpayers filing jointly who have three or more qualifying children (up from a total of $6,269 for tax year 2016).

Benefits

For tax year 2017:

- The monthly limitation for the qualified transportation fringe benefit is $255.
- The monthly limitation for qualified parking is $255.
- The dollar amount used to determine the penalty for not maintaining minimum essential health coverage is $695 (this amount is for calendar year 2017).
- The adjusted gross income amount used by joint filers to determine the reduction in the Lifetime Learning Credit is $112,000 (up from $111,000 for tax year 2016).

Estate and gift tax amounts

- Estates of decedents who die during 2017 have a basic exclusion amount of $5,490,000 (up from a total of $5,450,000 for estates of decedents who died in 2016).
- For 2017, the exclusion from tax on a gift to a spouse who is not a U.S. citizen is $149,000 (up from $148,000 for 2016).
- The annual exclusion for gifts remains at $14,000 for 2017.

Colorado: Management Fees Taxable When Combined With Sales of Taxable Services

The Colorado Department of Revenue recently issued a General Information Letter addressing whether a company's so-called management fee was subject to sales tax. The taxpayer provided repair and maintenance services for clients that owned large fleets of motor vehicles. As part of its services, the taxpayer maintained a database with details of all maintenance performed on the client's vehicles. Clients were charged a "management fee" for access to the database, which was separately-stated on client invoices.

Under Colorado law, computer software made available to consumers by an application service provider (ASP) is not tangible personal property and, therefore, charges for access are not subject to sales tax. However, if the sale of a nontaxable service is inseparable from the sale of a taxable service, i.e., the buyer is required to buy the nontaxable service as part of its purchase of taxable goods, then the charges for nontaxable services are included in the sales tax base. The Department concluded that if the taxpayer's clients were required to purchase the management service when purchasing repair and maintenance services, then the management fee was included in the calculation of sales tax. This was the result even if the management fee was separately stated on the invoice.

Louisiana: Proposed Regulations Released on Market-Based Sourcing and Related Party Expense Disallowance Rules

A proposed regulation issued by the Department of Revenue is intended to implement certain corporate tax changes enacted earlier this year—provisions that require a corporation to add back otherwise deductible interest expenses and costs, intangible expenses and costs, and certain management fees incurred with related members. The proposed regulation defines key terms that were not defined in the law—such as "management fees," "intangible expenses," and " indirectly paid." Much of the proposed regulation provides guidance on when the statutory exceptions to the addback requirements will be allowed, and how they must be documented.

Another proposed regulation addresses sourcing sales other than sales of tangible personal property. During the second special session, Louisiana lawmakers adopted single-factor apportionment and market-based sourcing. Effective for tax years beginning on or after January 1, 2016, sales other than sales of tangible personal property will be sourced to Louisiana if the taxpayer's market for the sale is in the state. The proposed regulation sets forth rules for determining to what extent a taxpayer's market for a sale is in Louisiana, rules for reasonably approximating the market state if the state of assignment cannot be determined under the regular rules, and guidance on the when receipts are excluded from the sales factor entirely. A public hearing on both proposed rules will be held on November 30, 2016.

Tennessee: New Rule Adopts Economic Nexus Standard for Out-of-State Dealers

The Tennessee Department of Revenue recently approved a new rule that adopts an economic nexus standard for sales and use tax purposes. The rule applies to out-of-state dealers that engage in regular or systematic solicitation of Tennessee consumers by any means. Under the rule, if such dealers make sales exceeding $500,000 to Tennessee consumers during the calendar year, they are considered to have substantial nexus with the state. By March, 1, 2017, out-of-state dealers meeting these tests are required register with the Department of Revenue. They must begin collecting and remitting sales and use taxes by July 1, 2017. Dealers that meet the $500,000 threshold after March 1, 2017 are required to register and begin collecting and remitting by the first day of the third calendar month following the month in which the dealer met the threshold.

The rule is subject to review by committees in both houses of the Tennessee legislature, and legislative approval is required before the rule can become permanent. Given the potential for controversy over the rule, the ultimate outcome is a bit uncertain. Interestingly, in its response to the comments submitted on the rule, the Department stated it believes the rule is "permissible under the Commerce Clause" and that there is a "strong possibility" that the U.S. Supreme Court will distinguish or reconsider Quill. The Department also reminds taxpayers that, in lieu of collecting the local rate applicable to each jurisdiction, remote sellers have the option of collecting a single local rate of 2.25 percent, in addition to the 7.0 percent state rate, on all sales made to in-state customers. Please stay tuned to TWIST for future updates on the Tennessee rule and the efforts to overturn Quill.

Section 385 final regulations: Initial reactions

On October 13, the Treasury Department and IRS released final and temporary section 385 regulations (hereinafter the "Final 385 Regulations") addressing the treatment of related party debt for U.S. tax purposes. These regulations had been proposed on April 4, 2016 (the "Proposed 385 Regulations").
(Please see the separate full article on this subject)

Final regulations: Research credit for internal use software

On October 3, the Treasury Department and IRS released for publication in the Federal Register final regulations (T.D. 9786) concerning the application of the credit for increasing research activities pursuant to section 41 for computer software that is developed by or for the taxpayer, for the taxpayer's internal use—i.e., "internal use software."

The final regulations [PDF 247 KB] adopt rules that were proposed in January 2015, with changes reflecting amendments made in response to comments that were received about the proposed regulations. Examples are included in the final regulations to illustrate application of the general process of experimentation requirements to software.

The final regulations will be published in the Federal Register on Tuesday, October 4, 2016, and are applicable to tax years beginning on or after the date of their publication in the Federal Register. The effective date from the proposed regulations is generally retained with slight modifications; however, the preamble states that the IRS will not challenge return positions consistent with all of the paragraph of (c)(6) of these final regulations or all of the paragraph of (c)(6) of the proposed regulations for any tax year that ends on or after January 20, 2015.

KPMG observation

The publication of internal use software (IUS) final regulations is a significant achievement by Treasury and the IRS, and the regulations will hopefully lead to significantly less controversy between taxpayers, practitioners, and the IRS.

The final regulation affect nearly every business, and many companies have been shying away from claiming credits resulting from their software development activities used to support their business because the area has been fraught with controversy for the past 15-plus years. As a result, now is a good time for taxpayers to further review whether they may be eligible for research credits regarding software development.

September 2016

Sourcing multi-year compensation, stock options, for foreign tax credit limitation

The IRS Large Business and International (LB&I) division publicly released a "practice unit"—part of a series of IRS examiner "job aides" and training materials intended to describe for IRS agents leading practices for specific international and transfer pricing issues and transactions—that concerns the sourcing of multi-year compensation arrangements, including stock options, with respect to the foreign tax credit limitation.

Specifically, the practice unit provides:

- An overview for the sourcing of multi-year compensation arrangements, including stock options, for the purpose of computing the foreign tax credit limitation
- A brief explanation of how equity-based compensation, such as statutory stock options and non-statutory stock options, is taxed

The practice unit (release date of September 23, 2016) is available on the IRS practice unit webpage.

KPMG observation

The LB&I division uses the practice units to identify areas of strategic importance to the IRS, provide insight as to how IRS examiners will approach various transactions, and generally provide an understanding of the context in which an IRS examiner will approach a particular issue or transaction. Taxpayers (and their tax advisers) facing an IRS examination or concerned with issue(s) presented by the practice units will want to review the relevant practice units, so as to have a better understanding of the issues that may arise either prior to or during an examination. For instance, the IRS practice units typically provide information that can help taxpayers:

- Plan for appropriate documentation during return preparation
- Effectively approach certain elections or certain transactions
- Respond appropriately to IRS correspondence

For taxpayers selected for a pending IRS examination, the practice units can provide information that may assist with preparation for the examination. For taxpayers actually under examination, the practice units may provide information that can assist taxpayers respond to IRS requests

Pennsylvania: Department of Revenue Issues Information on Upcoming Amnesty

On July 13, Governor Tom Wolf of Pennsylvania signed House Bill 1198, which made several changes to the Commonwealth's tax code and established a tax amnesty program for a to-be-determined period. The Department of Revenue recently issued comprehensive guidance, including guidelines and an FAQ document, explaining various aspects of the upcoming amnesty. Notably, the Department confirmed that the amnesty program will be held from April 21, 2017 through June 19, 2017.

The guidelines document outlines the steps and requirements for participation in the program and states that the Department will be issuing notices to delinquent taxpayers that may wish to take advantage of the amnesty opportunity. A taxpayer with an active administrative or judicial appeal is eligible to participate in the program, but must withdraw any administrative or judicial appeal relating to periods accepted under amnesty. House Bill 1198 adopted a five percent post-amnesty penalty for taxes owed that are not satisfied during the amnesty period. The penalty will not apply to taxpayers with active appeals, or entities that are in bankruptcy. Finally, the guidance confirms that participation in the 2017 amnesty will bar a taxpayer from participating in any future amnesty, and that taxpayers that participated in the 2010 amnesty are prohibited from participating in the 2017 program.

Texas: Receipts from Sales of Natural Gas Sourced to Where Loaded on Chartered Vessels

The Texas Comptroller recently issued a private letter ruling addressing how receipts from sales of "liquefied natural gas" (LNG) should be sourced under Texas' rules for sourcing sales of tangible personal property. The taxpayer at issue liquefied the natural gas at its Texas facility, then loaded the gas onto vessels for export. The purchasers of the LNG did not own the vessels, but chartered the vessels under so-called time charter agreements. Under these agreements, the vessel's owner furnished a crew and operated the vessel, but the charterer

(here the taxpayer's customer) designated the ports of call and the cargo to be carried. The taxpayer requested guidance on whether its customers took delivery of the LNG when it was loaded onto a chartered vessel docked in a Texas port.

Under Texas law, receipts from sales of tangible personal property are apportioned to Texas if the purchaser takes delivery of the property in Texas–even if the property is subsequently transported outside of the state. A Texas regulation further provides that tangible personal property loaded onto a vessel or tanker that the purchaser of the property leases and controls, or owns, is sourced to Texas if the vessel is docked in Texas. Thus, the issue was whether the taxpayer's customers were in control of the vessels chartered under the so-called time charter agreements. The taxpayer suggested that the appropriate standard to apply was "operational control," which narrowly considers which party is operating the vessel and is responsible for ensuring that it is operated safely and in compliance with Maritime law. In the instant case, operational control would remain with the vessel's owners and the taxpayer's customers would not be deemed to be in control. The Comptroller, relying on a federal case addressing whether a time-charter agreement should be treated as a lease or service agreement under the Internal Revenue Code, rejected this approach. The charter agreements in the federal case were very similar to the ones entered into by the taxpayer's customers and indicated that the charterer maintained control over every aspect of the use of the vessel. The Comptroller concluded that the control over the use of the vessel was more important than the operational control exercised by the crew. Thus, when the LNG was loaded onto a vessel in a Texas port and the vessel was chartered by the LNG purchaser under a time-charter-agreement with industry-standard terms, the LNG was considered delivered in Texas and the receipts were included in the Texas sales factor numerator.

August 2016

Final regulations: Defining "married couples" for tax purposes

On August 31, the Treasury Department and IRS released for publication in the Federal Register final regulations (T.D. 9785) concerning the definition of married couples for purposes of provisions in the Code.

The final regulations [PDF 250 KB] reflect the holdings of the U.S. Supreme Court in *Obergefell v. Hodges and Windsor v. United States* as well as IRS guidance provided in Rev. Rul. 2013-17.

A notice of proposed rulemaking was issued in October 2015. Treasury and the IRS received written comments concerning the proposed regulations. After considering those comments, the proposed regulations—as revised—are adopted as final with today's release.

As noted in the preamble to today's final regulations, the purpose of the regulations is to define marital status for federal tax law purposes. The IRS and Treasury have determined that marriages of couples of the same sex are to be treated the same as marriages of couples of the opposite sex for federal tax purposes.

Effective date

The final regulations are effective September 2, 2016 (the date of their publication in the Federal Register). Rev. Rul. 2013-17 will be obsolete as of that date; however, taxpayers may continue to rely on guidance related to the application of Rev. Rul. 2013-17 to employee benefit plans and the benefits provided under such plans, including Notice 2013-61, Notice 2014-37, Notice 2014-19, Notice 2014-1, and Notice 2015-86 to the extent they are not modified, superseded, obsoleted, or clarified by subsequent guidance.

Rev. Proc. 2016-48: Retroactive section 179 expensing, 50% bonus deprecation

On August 26, the IRS released an advance version of Rev. Proc. 2016 -48 that provides guidance to taxpayers with a tax year beginning in 2014 and ending in 2015 and that had filed their 2014 federal income tax returns prior to enactment of the Protecting Americans From Tax Hikes Act of 2016 (PATH Act) on how to adopt these measures on their 2014 returns:

- The permanent extension of the rule under section 179 allowing taxpayers to expense an amount of certain depreciable property
- The five-year extension (from 2015 through 2019) of the 50% "bonus depreciation" deduction
- The five-year extension of an election allowing a corporation to forgo bonus depreciation—and to use straight-line depreciation—on its qualified property, and instead to accelerate the ability to use additional alternative minimum tax (AMT) credits, through 2019 (through 2020, if a taxpayer has qualified long-production period property in that year)

North Carolina: Governor Announces Corporate Income Tax Rate Reduction Will Occur

Because tax collections have exceeded a threshold amount, the corporate income tax rate will be reduced from 4.0% to 3.0% beginning January 1, 2017.

Notice 2016-48: Guidance for implementing changes to ITIN program

On August 4, the IRS released an advance version of Notice 2016-48 to implement changes made to the individual taxpayer identification number (ITIN) program as made by legislation enacted in December 2015 (the Protecting Americans from Tax Hikes Act of 2015 or the "PATH Act").

Notice 2016-48 [PDF 53 KB] explains the legislative changes, reports how the IRS will implement the changes, and states the potential consequences for taxpayers who do not renew an ITIN as required. Notice 2016-48 sets forth guidance concerning:

- The ITIN application process
- Rules for when ITINs must be renewed beginning in 2017
- How to renew an ITIN (based on whether the ITINs have or have not been used in the past three consecutive years) and rules for ITINs issued before 2013 and currently in use
- Consequences for taxpayers that do not renew an ITIN

- The effects on holders of expired ITINs who have or become eligible for a social security number (SSN)
- The use of an ITIN solely on an information return

With this guidance, the IRS explained that ITINs issued before 2013 and that have been used on a federal tax return in the past three years will need to be renewed pursuant to the following renewal schedule:

- ITINs issued before 2008 will remain in effect until January 1, 2017.
- ITINs issued in 2008 will remain in effect until January 1, 2018.
- ITINs issued in 2009 or 2010 will remain in effect until January 1, 2019.
- ITINs issued in 2011 or 2012 will remain in effect until January 1, 2020.

A related IRS release—IR-2016-100 (August 4, 2016)—notes that some of the changes require taxpayers to renew their ITINs beginning in October 2016 and that ITINs that have not been used on a federal tax return at least once in the past three years will no longer be valid for use on a tax return unless renewed by the taxpayer.

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