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U.S. business update for Japanese companies

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KPMG's U.S. Japanese Practice

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U.S. CEO Outlook 2016

Now or Never, CEOs mobilize for the fourth industrial revolution

The Fourth Industrial Revolution is here, and it's upending business models, blurring lines between industries and companies, and demanding an entirely new way of thinking about business.

KPMG's survey of 400 U.S. chief executives sheds light on how companies are transforming in times of extraordinary change. CEOs say that rapidly evolving technology, and the speed of transformation it unleashes, are making the next three years more critical for their industry than the previous 50. While they're confident about their growth prospects, they recognize that they are operating in a new world – and they'll have to operate differently to succeed.

Highlights:

The next three years are business critical. Two-thirds of CEOs believe that the next three years will be more critical for their industry than the previous 50 years. While confident about growth prospects, leading CEOs believe technological change will be one of the biggest factors impacting growth over the next three years, second only to economic factors.

Industries are transforming faster than ever before. The ability to know how their products are used and where their services are needed at a very granular level is already transforming many business processes and in some cases, the entire make-up of the organization. Four out of ten CEOs (39%) believe they will be running a completely different entity in the next three years.

Innovation is a matter of time. A majority (85%) of CEOs admit vulnerability about the amount of time they have to spend strategizing about the forces of disruption and innovation and an overwhelming majority are apprehensive about the integration of basic automated business processes with artificial intelligence and cognitive processes.

Customer focus and investment will increase. Customer loyalty is a concern for 89% of CEOs. Just over half believe they are not keeping pace with customer expectations. In fact, having a stronger client focus was identified as the top strategy priority for the CEOs, and 86 percent of the CEOs are concerned about how to keep up with the differing wants and needs of millennials.

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Understanding Stock Option Deductions in M&A

Tax professionals often encounter many of the same tax questions and issues in corporate acquisitions, but one issue generally requires many of us to think through the basic rules each time to reach the correct answer: In which tax period is the target entitled to deduct an amount paid to cash-out stock options? That is because the answer can vary depending on the method of accounting used by a target (e.g., cash method or accrual method), the type of a target entity (e.g., C corporation or S corporation), as well as the type of an acquiring entity, the type of acquisition (e.g., asset purchase or stock purchase), and the timing of payments. Also, the amounts involved are usually significant enough to warrant some caution.

Incentive compensation in the form of stock options has been one of the dominant forms of long-term equity-based compensation for a number of U.S. corporations since the 1950s, although the use of stock options has lessened compared to other forms of incentives.[1] A stock option is a right to buy a company's stock in the future at a specified "exercise price" (generally the fair market value of the share on the date the option is granted). The hope is that the exercise price is lower than the stock price at the time of exercise where a company's stock price increases over time. Stock options usually vest over time and can thus be incentives for an employee to stay with a company for a long term.

In this article, we go over the basic rules with regard to the deduction for a cash-out of stock options in an acquisition context. Due to the complexity of the rules, our discussions in this article are limited to a cash-out of nonstatutory stock options (that are not subject to §409A[2]) in a taxable acquisition context (i.e., statutory stock options, nonqualified deferred compensation and cancellation of stock options in a tax-free acquisition context are excluded from the scope of this article). Also, we do not address any issue arising under §280G in this article.

Income taxation of stock options in general

§83 governs taxation of stock options for any "service provider," which includes both an employee and an independent contractor (although this article references employees, the rules are the same for other service providers). §83 also governs the deduction and deduction timing rules for the employer. If an employee is granted an option in connection with the performance of services and if such option has "a readily ascertainable fair market value" (as narrowly defined in the regulations) at the time the option is granted, the employee is required to include the value of the option as compensation income at the time of grant[3] (very rarely do options meet the "readily ascertainable" rules). Typically, an employee is granted an option without a "readily ascertainable fair market value" and thus the employee is required to report the "spread" as employee compensation at the time of exercise, or disposition of the option. The "spread" is the amount of the fair market value at the time of the exercise (or the disposition) over the exercise price paid by the employee.[4]

An employer is generally allowed a tax deduction equal to the "spread." However, the timing of the deduction can be unexpected in an acquisition.[5]

§83 deduction timing

If an employer grants restricted shares to an employee (transferring the shares into an employee's name on the date of grant, but subjecting the shares to a substantial risk of forfeiture, usually based on continued service with the employer), the general §83 deduction rule provides that the employer can only take the deduction for the taxable year of the employer in which or with which the employee's taxable year of income inclusion ends.[6]

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1 Joseph E. Bachelder III, "What has happened to stock options?" McCarter & English, LLP (October 2, 2014)

2 §409A generally provides that unless specified requirements are satisfied, all amounts deferred under the plan are currently includable in gross income as soon as they "vest" (under these rules, vesting specifically means that the promised amounts are no longer subject to a "substantial risk of forfeiture"). Unless otherwise stated, all references to the "§" or "Section" are to the Internal Revenue Code of 1986, as amended, and all references to the "Regulations" or to "Treas. Reg." are to the Treasury Regulations promulgated thereunder.

3 §83(a); Treas. Reg. § 1.83-7.

4 Id.

5 We note that although a taxpayer may not deduct certain costs it incurs to facilitate a transaction, Treas. Reg. § 1.263(a)-5(d)(1) states employee compensation is an amount that does not facilitate a transaction.

6 §83(h); Treas. Reg. § 1.83-6(a).

Example:
Employee vests in restricted shares on February 20, 2015. Employee includes the fair market value of the vested shares as taxable compensation in the employee's taxable year, the calendar year ending December 31, 2015. An employer with a March 31 fiscal year can only deduct the compensation amount in its taxable year ending March 31, 2016 (because the employee's December 31, 2015 year ends during the employer's tax year ending March 31, 2016). Under this rule, there may be a deferral of a deduction for a fiscal year taxpayer.

However, §83 also provides an exception to the §83 deferred deduction timing rule for certain types of equity compensation. This exception can be especially useful in relation to an exercise or a cash-out of stock options upon acquisition.

The exception applies only if the property received by an employee is substantially vested upon transfer. This rule generally applies for options because on exercise, most employees receive fully vested shares. However, if the employee exercises options and receives unvested shares, the exception is not available. Under the exception, the deduction is allowed to the employer in accordance with its method of accounting (rather than the year in which or with which the employee's taxable year including the income ends).[7] A deduction is allowed under an accrual method of accounting when all events to establish a liability have occurred, the amount of a liability can be determined with reasonable accuracy, and the economic performance has occurred with respect to the liability.[8] This means that the liability with respect to a cash-out of stock options for a target company using an accrual method of accounting is generally fixed when the optionee/employee becomes entitled to the payment under the agreement, which generally occurs on closing, assuming the payment is made within 2.5 months after the year-end. Thus, under the exception, the employer can generally take the deduction in the employer's year in which the employee exercises an option, or in which the option is cancelled for cash (so long as the cash is paid to the employee within 2.5 months after the year-end).[9]

Often, a target company has outstanding stock options that are either vested or unvested. To the extent the options vest because of the transaction, such outstanding stock options are often cancelled, and instead, the employee receives cash equal to the "spread" at the date of the transaction (however, sometimes a portion of the "spread" may be paid later under escrow or earn-out terms).

IRS's positions on a deduction of a cash-out of stock options

The IRS addressed its positions on the deduction timing for a cash-out of stock options in 2003 and 2012.

In 2003, the IRS provided in Revenue Ruling 2003-98 guidance on an employer's deduction of nonstatutory stock options in four situations involving an acquisition, addressing which entity is entitled to a deduction and in which tax year.[10] The facts in Situation 3 of Revenue Ruling 2003-98 are depicted as follows, to the extent relevant to this article:

On January 1, 2003, Employee begins employment with Company M with a September 30 year-end and is granted a nonstatutory option (which has no readily ascertainable fair market value upon grant and is not exercisable until January 1, 2006) to purchase a number of shares of the Company M common stock. On November 15, 2006, Company N with a September 30 year-end acquires all of the outstanding shares of Company M for cash (without a §338 election). The options are outstanding until January 15, 2007, when pursuant to the terms of an agreement, Company N cancels the options in exchange for cash.

The IRS ruled that because the consideration received on a cancellation of the option upon the disposition of the Company M option is fully vested cash, the exception under Treas. Reg. §1.83-6(a)(3) to the general timing rule for deductions in §83(h) applies, and thus to the extent that the compensation is otherwise deductible, Company M, and only Company M, is entitled to deduct the cash actually paid using its method of accounting for its taxable year ending September 30, 2007.[11] This guidance is very helpful in that it confirmed that the service recipient (i.e., Company M) is entitled to a deduction and that the exception under Treas. Reg. §1.83-6(a)(3) should apply to a cash-out of stock options. However, it did not address a deduction timing issue involving a consolidated return (i.e., where a target's tax year ends upon acquisition because the target leaves a seller's consolidated group or joins an acquiring's consolidated group, there is a question of whether the deduction is allowed in a pre-closing tax year or in a post-closing tax year of the target).[12]

In 2012, the IRS addressed this question in GLAM 2012-010 by providing its view on how the "next-day rule" in the consolidated return regulations should be applied to a deduction of nonstatutory stock option expenses (and certain other expenses) in an acquisition context.[13] The next-day rule generally provides that when a transaction occurs on the day of the subsidiary member's change of status that is properly allocable to the portion of the day after the transaction, the subsidiary and all persons related to it immediately after the transaction must treat the transaction as occurring at the next day.[14]

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7 Treas. Reg. § 1.83-6(a)(3).

8 Treas. Reg. § 1.461-1(a)(2).

9 Note, however, compensation paid for services could be categorized as a "deferred compensation" if the payment is made after 2.5 months after the year-end of the employer. As an example, if some of the option spread will be paid later, out of escrow or only on reaching an earn-out, this later payment must be designed to satisfy the §409A deferred compensation rules. According to Treas. Reg. § 1.404(b)-1T(c), a plan, or method or arrangement, shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2.5-month period. Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is not considered paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that such salary or bonus is received by the employee on or before the end of the applicable 2.5-month period.

10 Rev. Rul. 2003-98, 2003-2 C.B. 378.

11 Id.

12 In general, under the "end-of-the-day rule" in Treas. Reg. § 1.1502-76(b)(1)(ii)(A), if a corporation (S) becomes or ceases to be a member of a consolidated group, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all Federal income tax purposes at the end of that day. Unless the "next-day rule" applies, the member allocates its items of income or loss through the end of the day on the acquisition date to the pre-closing tax year.

13 GLAM 2012-010 (11/30/2012). Note that a GLAM should not be used or cited as precedent. See also Proposed Reg. § 1.1502-76(b)(2)(ii)(C)(9) (addressing some of the concerns articulated by commentators, but reaffirming the position taken in the GLAM).

14 Treas. Reg. § 1.1502-76(b)(1)(ii)(B). If, on the day of S's change in status, a transaction occurs that is properly allocable to the portion of S's day after the event resulting in the change, then S (and all persons related to S under §267(b) immediately after the event) must treat the transaction for all Federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of S's day after the event resulting in S's change in status will be respected if it is reasonable and consistently applied by all affected persons.

The facts relating to a deduction of the stock option expenses in GLAM 2012-010 are provided as follows:

> A subsidiary of Acquiring (a calendar year, common parent of a consolidated group) merges with and into Target (a calendar-year, accrual-basis C corporation) and Target's shareholders exchange their Target stock for cash (without a §338 election). Target thus becomes a member of the Acquiring's consolidated group at the end of November 30, 20XX (pursuant to which two short tax years are created for Target: a pre-closing short tax year for January 1, 20XX through November 30, 20XX and a post-closing short tax year for December 1, 20XX through December 31, 20XX).
>
> At the time of the acquisition, Target has outstanding nonqualified stock options (without readily ascertainable fair market value at grant) issued to certain of its employees for which Target is obligated to pay certain amounts for and in cancellation of their stock options in the event of a change in control. Under the terms of its agreements with its employees, within several days after the acquisition, Target pays its employees (using its own funds or funds received from Acquiring) the amounts required under the terms of the option agreements. Target becomes entitled to a deduction on November 30, 20XX.

In the GLAM, the IRS concluded that the next-day rule is inapplicable by its terms, and it is neither proper nor reasonable to allocate deductions from the liabilities to the post-closing portion of the acquisition date. Consequently, the IRS further concluded these deductions are governed by the end-of-the-day rule[15] and are properly reported on Target's short-year return for the taxable year ending November 30, 20XX (i.e., pre-closing short tax year). The IRS provided three main reasons for its conclusion: (i) Target's obligation to pay and the amount of its liability become fixed and determinable upon closing; (ii) the liability relates to the performance of services for Target by employees (i.e., transactions) before the acquisition; and (iii) the corresponding deductions are not attributable to any "transaction" on the acquisition date other than the acquisition itself.

This conclusion has been the matter of some debate, as many practitioners do not agree with the analysis provided by the IRS in the GLAM.[16] Tax practitioners argue that: (i) the IRS observation that the services often were performed historically fails to acknowledge that most items eligible for next-day treatment similarly reflect the recognition of items (such as gain or loss) that economically arose before the change date; (ii) the fact that there is no transaction triggering the deduction other than the change of control itself is also true of other circumstances that are explicitly eligible for next-day treatment under the existing regulations; and (iii) next day treatment is appropriate in cases where, without the acquisition transaction, there would not have been a change-of-control which triggered the cash-out of the stock options. Moreover, the GLAM ignores the fact that the next-day rule regulations specifically provide that a determination as to whether a transaction is properly allocable to the portion of the target's day after the event resulting in the target's change in status will be respected if it is reasonable and consistently applied by all affected persons.[17] In addition, tax practitioners point out that not applying the next-day rule to the cash-out of stock options in this instance would cause a double detriment to the buyer where the target is a loss corporation and the acquisition causes a section 382 limitation[18] and thus would not be correct from a tax policy perspective.

Although allocating the deduction for the stock option expense to the preacquisition tax period (as advocated in the GLAM) may be a "reasonable" approach, many tax practitioners generally view applying the next-day rule to allocate the stock option expense to the post-acquisition tax period as equally reasonable, and that applying the next-day rule in this instance would be sustained at the more-likely -than-not level.[19] There are other approaches that may permit the buyer in a transaction to take the stock option deduction. The following examples apply the above rules to a number of situations where a corporation acquires a domestic target corporation or its business similar to those in which a foreign corporation, such as a Japanese corporation, or its U.S. subsidiary acquires a domestic target corporation to illustrate the typical results.

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[15] See note 12.

[16] See, for example, Deanna Walton Harris, Mark Hoffenberg, and Jeff Vogel, "Questioning the IRS's Application of the Next-Day Rule," Tax Notes (10/13/2014) and Anne Batter and Christine Sloan, "IRS Addresses Controversial Option Deduction Issue in GLAM 2012-010," Journal of Corporate Taxation (Jul/Aug 2013).

[17] Note that the regulations provide factors to consider in determining whether an allocation is reasonable, such as consistency with other Code or regulation provisions or facts indicating a transaction is not properly allocable to the post-acquisition period.

[18] The position would cause a double detriment to the acquirer in that first, the deduction would be subject to a section 382 limitation, and second, would increase Net Unrealized Built-in Loss or NUBIL, which would become part of the loss subject to a limitation (or decrease Net Unrealized Built-in Gain or NUBIG, which would increase the amount of a section 382 limitation).

[19] This view will likely change once the proposed next-day regulations become final.

Examples

We assumed in all situations that (i) Target and Acquiring both use an accrual method of accounting unless otherwise stated; (ii) Target uses a calendar year-end and Acquiring uses a March 31 year-end; (iii) Target has outstanding stock options (vested or unvested) for certain employees; (iv) Acquiring acquires the outstanding stock of Target on June 30, 2015 (Closing Date); (v) all unvested stock options become vested upon closing and all options are cancelled for cash upon closing under the terms of stock option agreements; (vi) the actual cash payment for the options is made within a few days after the closing date. However, different facts may provide different results. Always check with a tax adviser familiar with the §83 rules and other compensation rules before taking a deduction with regard to equity compensation.

Situation A:

The stock of a U.S. target company (Target), a C corporation owned by noncorporate shareholders (e.g., partnerships and/or individuals), is directly acquired by a foreign corporation (Acquiring). The Target remains in existence and a §338 election is not made. In this case, Target's tax year does not end on the closing and thus it files only one tax return for its calendar year unless it changes its tax year-end.

As Target does not close its year-end at closing, Target would claim the deduction, with regard to the cash actually paid for the cancelled options, for its tax year ending December 31, 2015. Often, the buyer and the seller agree to use a "closing of the books" method to allocate tax liability between hypothetical pre- and post-closing periods. To avoid any conflict, we generally suggest that the parties agree on which period the deduction will be allocated for purpose of determining tax liability between the seller and the buyer.

Situation B:

Same as Situation A except that Target is acquired by a member of a U.S. consolidated group (Acquiring Group), the parent of which is owned by a foreign corporation. In this case, Target's tax year ends on the closing (i.e., June 30, 2015) and Target has two short tax years: a pre-closing tax year from January 1, 2015 through June 30, 2015 (which is reported on the Target's separate company tax return and a post-closing tax year from July 1, 2015 to March 31, 2016 (which becomes part of the Acquiring Group's consolidated return).[20]

If we use the conclusions in GLAM 2012-010, a deduction would be claimed for the short tax year ending on the closing date (i.e., June 30, 2015). From the Acquiring Group's perspective, this result may not be favorable especially if the Acquiring Group assumes the liability and/or if the Target's pre-closing short year generates an NOL that would be subject to an annual limitation under §382 (because of the ownership change triggered due to the acquisition). On the other hand, if, contrary to GLAM 2012-010, we apply the next-day rule, a deduction would be claimed for the post-closing tax year.

Situation C:

Same as A except that the U.S. target company (Target) is an S corporation which is owned by one individual (Seller). A §338 election is not made. In this case, Target's tax year as an S corporation terminates at the end of the day before the closing (i.e., June 29, 2015) and its tax year as a C corporation starts at the beginning of the closing date (i.e., June 30, 2015).[21]

A deduction would be claimed for the C corporation tax year starting on the closing date as Target becomes entitled to the deduction on the closing date (i.e., June 30, 2015). This result would likely be favorable to Acquiring, but we generally suggest that the seller and the buyer agree on the timing of the deduction prior to the closing to avoid any inconsistent treatment among the parties. This would also be the result if Target were acquired by Acquiring Group (as in Situation B).[22]

Situation D:

Same as B except that Target uses a cash method of accounting. After Target joins the Acquiring Group's consolidated group, Target uses an accrual method of accounting. As in B, Target's tax year ends on the closing (i.e., June 30, 2015) and Target has two short tax years: a pre-closing tax year from January 1, 2015 to June 30, 2015 (which is reported on the Target's separate company return) and a post-closing tax year from July 1, 2015 to March 31, 2016 (which becomes part of the Acquiring Group's consolidated return).

As Target changes its overall method of accounting from a cash method to an accrual method in its post-closing tax year, Target would be required to compute the impact from the change (i.e., a section 481(a) adjustment) as of the beginning of the post-closing tax year and include such impact in gross income of the post-closing tax year.[23] The deduction from the stock options should be included as part of the section 481(a) adjustment, which Target would recognize in the post-closing tax year(s).[24] Accordingly, Target would take the deduction into account in one or more post-closing tax years and, if the section 481(a) adjustment is negative, is entitled to a deduction on the post-closing tax year from July 1, 2015 to March 31, 2016. On the other hand, if Target makes the payment on the closing date, Target would likely be entitled to a deduction in the short year ending on the closing, but the rule is unclear as the next-day rule may apply to treat the payment as occurring at the beginning of the next day after the closing if it is properly allocable to the post-closing period.[25]

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20 Note that following the acquisition, Treas. Reg. §1.1502-76(a) requires Target to change its accounting period to adopt the consolidated group's annual accounting period (i.e., a March 31 tax year end).

21 §1362(e)(1); Treas. Reg. § 1.1362-3(a).

22 Note, however, that if Target is acquired by a member of a U.S. consolidated group (or if Target and a U.S. Acquiring corporation elect to file a consolidated return), Prop. Reg. § 1.1502-76(b)(1)(ii)(B)(2), when it is finalized, would change this result. Under the new "previous-day rule," the deduction would be required to be allocated to the S corporation tax year. According to the Preamble to the proposed regulation, the proposed regulations added this "previous-day rule," which requires extraordinary items (such as compensation-related deductions) resulting from transactions that occur on the termination date (but before or simultaneously with the event causing the target's status as an S corporation to terminate) to be allocated to the target's tax return for the short period that ends on the previous day (that is, the day preceding the termination date).

23 §481(a).

24 Rev. Proc. 2011-14, 2011-4 I.R.B. 330. If the net adjustment is positive (unfavorable), the adjustment is recognized over four years and if the net adjustment is negative (favorable), the adjustment is recognized in one year.

25 Treas. Reg. § 1.1502-76(b)(1)(ii)(A).

Situation E:

Same as B except that substantially all assets of a U.S. target corporation are purchased and certain liabilities including the stock option liability are assumed by a member of the Acquiring Group. In this case, Target's tax year does not end as of the closing, but rather continues until it potentially liquidates with and into its owner(s). The purchaser has only purchased assets and assumed the liability, and thus, the Webb case[26] generally suggests that the asset buyer cannot take a tax deduction for the compensation, because the compensation liability is considered to be assumed by the asset buyer as part of the acquisition, and therefore would be added to the basis of the acquired assets. Thus, under this arrangement, if the amounts are not fully paid by the date of the change in control, the buyer would likely amortize the liability as part of the purchase price (assuming it is capitalized to an amortizable asset, such as goodwill).

Situation F:

Same as C except that a §338(h)(10) election is made. A section 338(h)(10) election makes a stock acquisition a deemed asset acquisition for federal income tax purposes. In a deemed asset transaction, the old target is treated as if it sold all its assets and transferred all liabilities to an unrelated party (the new target) as of the end of the closing date[27] and immediately liquidated. In this case, the old target's tax year as an S corporation terminates at the end of the closing date (i.e., June 30, 2015) and the new target's tax year as a C corporation starts at the beginning of the following date (i.e., July 1, 2015).

In a deemed asset transaction, the new target assumes the old target's liability for a cash-out of stock options. Following the Webb case,[28] the new target would likely have to amortize the liability for the stock options as part of the purchase price (as discussed above in Situation E).

As seen in the above, each of the situations above may produce a different result. Careful attention and planning will help both the acquirers and the sellers obtain supportable tax positions.

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Questions?
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[26] David R. Webb Co., Inc. v. Commissioner, 52 AFTR 2d 83-5104 (1983).

[27] §338(a)(1) provides that if a purchasing corporation makes an election under this section, then, in the case of any qualified stock purchase, the target corporation shall be treated as having sold all of its assets at the close of the acquisition date at fair market value in a single transaction.

[28] See supra note 15.

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New Proposed 385 Debt/Equity Regulations

On April 4, 2016, as part of a new guidance package addressing "inversion" transactions, the United States Department of the Treasury ("Treasury") unexpectedly released new proposed regulations (the "385 Regulations") that would fundamentally alter the U.S. tax treatment of intercompany financing within multinational groups.

Despite the purported focus on inversions the 385 Regulations are not limited to companies that have engaged in inversion transactions. The rules will significantly affect most of all U.S. companies and groups that are part of a multinational group that is headquartered outside the U.S. The rules in particular are also designed to restrict the ability of foreign -owned U.S. groups to engage in "earnings stripping," or the use of intercompany debt to reduce the U.S. tax due on the profit arising from the U.S. business operations.

The U.S. tax system already contains several restrictions against "earnings stripping," such as the 50% EBITDA deduction limitation in Code Section 163(j); imposing withholding tax on payments of interest to related non-U.S. taxpayers, unless relieved by Tax Treaty; and special tax accounting rules that require actual payments of interest, instead of mere accruals, for such interest amounts to be deductible. Unlike these rules, the 385 Regulations do not change the tax treatment of the interest amounts. The 385 Regulations instead would treat the underlying debt instrument as equity for U.S. tax purposes, such that the yield on the instrument is not considered deductible interest. In doing so the 385 Regulations will significantly restrict (particularly in the context of internal group restructurings) the opportunities for foreign shareholders to make debt investments in their U.S. subsidiaries.

Overview of the proposed regulations

The 385 Regulations contain three primary areas of focus —Documentation Rules, Recast Rules, and the Bifurcation Rule. These rules apply to a corporate expanded group ("EG"), which is generally a section 1504(a) affiliated group (generally corporations connected by 80 % ownership of vote and value except that (1) the nonincludable corporations listed in section 1504(b) including non-US corporations, and (2) the common parent need not own 80% of another member directly, but it can own it indirectly as well, and (3) the group need be connected by ownership of stock constituting 80% of vote or value of a member, rather than vote and value).

Although the question of whether a distribution or acquisition of stock is related to the intercompany debt issuance is a "facts and circumstances" test, the proposed regulations provide a "per se" rule by which a debt instrument is automatically recharacterized as equity to the extent of distributions or acquisitions of stock of affiliates by the issuer during the 36-month period before and after the date of distribution or acquisition (the 72-month period).

Intergroup financing arrangements are a common feature of modern multinational tax and treasury functions. Every multinational organization will, at a minimum, be required to evaluate its internal financing functions (with respect to cash pooling loans, intercompany trade-related debt, term funding, etc.) for compliance with the Documentation Rules and to identify when newly issued debt is subject to the Recast Rules.

All instruments or contractual arrangements that (1) constitute indebtedness for U.S. federal income tax purposes, (2) are issued between members of an expanded group, (3) pursuant to certain transactions are subject to recharacterization under these rules. For example, a sale-leaseback or sale-repurchase agreement that is treated as debt for U.S. federal income tax purposes would be subject to recharacterization under these rules if the other conditions are met.

Documentation rules

The Documentation Rules require contemporaneous and ongoing documentation for certain debt instruments issued between EG members ("Expanded Group Instruments" or "EGIs"). Failure to comply with the Documentation Rules can result in the EGI being treated as equity. The Documentation Rules apply to EGIs issued after finalization of the 385 Regulations. Importantly, the 385 Regulations generally do not apply to debt issued between members of a U.S. consolidated group. Thus, intercompany debt between U.S. consolidated group members is exempt from the Documentations Rules.

The Documentation Rules require taxpayers to document (within 30 days of the debt's issuance) the parties' satisfaction of traditional debt indicia, including:

1. The obligation to repay a sum certain on one or more fixed dates
2. The holder's right to enforce traditional creditor's rights, and
3. That the issuer has the financial wherewithal to support treating the instrument as debt.

Taxpayers must also document the parties' ongoing performance under the instrument. Such documentation must be in place within 120 days of the relevant date. It would include showing that the issuer has timely made payments of interest and principal according to the loan's terms, and conversely, if a payment has been missed, showing the holder's resulting enforcement actions.

Recast rules

Under the Recast Rules, any debt issued between EG members can be re-characterized as stock for all U.S. federal tax purposes if the debt is issued in certain specified situations. The Recast Rules are proposed to apply to debt issued on or after April 4, 2016. Under a transition rule, debt issued on or after April 4, 2016—that would be recast before finalization of the 385 Regulations—is not recast 90 days after finalization.

The Recast Rules contain two components—a General Rule and a Funding Rule. The General Rule applies when a debt instrument is issued in one of the following situations:

1. As a distribution with respect to stock, wherein the recipient is a member of the issuer's EG
2. In exchange for stock of another EG member, or
3. As consideration in an asset reorganization whereby the issuer is the acquiring corporation vis-à-vis another EG member.

If the General Rule does not apply to a debt, the Funding Rule serves as a broad anti-abuse rule to prevent taxpayers from replicating the effects of the General Rule transactions over time. The Funding Rule applies when:

1. An EG member (the "Funded Member") borrows from another EG member (that is, is "funded"), and
2. The Funded Member makes a specified de-funding transaction within 36 months before or after the loan date.

Corresponding to the General Rule, de-funding transactions occur when a Funded Member does one of the following:

1. Makes a distribution of property to an EG member
2. Acquires stock in another EG member in exchange for property other than EG stock (subject to an exempt exchange exception), or
3. Is the acquiring corporation in an asset reorganization involving another EG group member, if a shareholder of the target receives boot pursuant to the reorganization.

As currently written, there are no intent-based exceptions to the 36 month look-back and look-forward periods.

When one of the Recast Rules applies, the recast debt is generally treated as stock as of the time of its issuance. If, however, the Funding Rule applies and the de-funding leg occurs in a tax year following the year of the borrowing, the recast debt is treated as stock as of the time of the de-funding transaction.

Several exceptions apply to the Recast Rules, as follows:

1. The Threshold Exception applies a de minimis rule if the aggregate amount of debt in an EG subject to the Recast Rules is below $50 million
2. The Current Year Earnings and Profits ("E&P") Exception limits the application of the General Rule and the Funding Rule annually through a series of complicated rules based on the EG member's current E&P
3. The Funding Rule does not apply to loans, such as trade payables, entered into in the ordinary course of the issuer's trade or business, and
4. The Funding Rule also does not apply if the de-funding transaction is an investment in a subsidiary, provided the stock of the subsidiary is held directly or indirectly for 36 months following the investment.

In addition, the Recast Rules do not apply to acquisitions of stock or assets from unrelated parties or to leveraged asset acquisitions within a group, including borrowing to acquire the stock of a disregarded entity that holds only non-stock assets.

The primary effect of recasting debt as stock is that interest payments will be classified as non-deductible dividends, and the repayment of principal will no longer be a tax-neutral event. More broadly, however, there are many open and unanswered questions regarding the collateral consequences (e.g., foreign tax credit, withholding tax, etc.) arising from the recast debt's equity classification.

Bifurcation authority

Lastly, the 385 Regulations contain another substantive rule that allows the Internal Revenue Service ("IRS") to re-characterize an instrument as part-debt and part-equity instead of the traditional all-or-nothing approach (the "Bifurcation Rule"). The 385 Regulations contain no meaningful guidance on how the Bifurcation Rule is to be applied. Accordingly, its impact is unclear. The Bifurcation Rule would apply to instruments issued after the date of finalization.

How will the new rules affect state taxes?

It also is far from clear how the new rules will trickle down to the state tax level. For example, separate filing states that do not follow the consolidated return rules may not follow the "consolidated group as one taxpayer" provision, which could greatly expand the rules' scope. The re-characterization results could also percolate into a variety of other state tax issues, such as the creditor's apportionment factor (if interest and dividends are sourced differently); thin cap and related party expense rules; and franchise tax determinations that are based on the federal tax balance sheet.

Comments on proposed regulations under section 385

Taxpayers, trade groups, and other commentators have been very critical of the 385 Regulations. By July 7, 2016, Treasury and the IRS received in excess of 150 comment letters about the proposed regulations under section 385. The government is obligated to review and consider these comments as part of the administrative process to finalize the proposed rules.

Treasury officials met with members of the Senate Finance and House Ways and Means committees regarding the 385 Regulations. A release from the Ways and Means Committee includes a comment from Chairman Kevin Brady (R-TX) about the "negative consequences of the proposed regulations."

Prior to a mid-July meeting about these concerns (organized by the Joint Committee on Taxation), members of Congress had written to Treasury Secretary Lew to express concerns about the proposed regulations. For example, a letter from Republican members of the Senate Finance Committee on July 1, 2016, followed two other letters to Secretary Lew expressing concerns regarding the section 385 proposed regulations—letters previously sent by both Republican and Democratic members of the House Ways and Means Committee.

So far, Treasury officials have broadly indicated that they are receptive to fixing some aspects of the proposed rules that may have been overbroad (by exempting some additional types of debt instruments) or produced unintended consequences. By all accounts, however, the government intends to finalize the 385 Regulations in largely their proposed form (at least in terms of function, if not scope) by the end of 2016 and before a new U.S. presidential administration takes office. Taxpayers should expect the rules to be finalized later this year and must begin reviewing their current capital structures, treasury and internal controls, and corporate development/M&A pipeline to assess potential traps and opportunities under the forthcoming new rules.

This article was prepared with assistance from and materials previously written by Ron Dabrowski (rdabrowski@kpmg.com) and Douglas Holland (dholland@kpmg.com) of KPMG LLP (US).

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

KPMG

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 Simplifies Accounting for Share-based Payments

Defining Issues 16-11 reports that the FASB recently issued an ASU intended to improve the accounting for share-based payment transactions as part of its simplification initiative.

Go to Defining Issues 16-11 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-share-based-payments-2016-09.pdf

EU Audit Reforms: The Countdown Begins

Defining Issues 16-12 examines where European Union countries are in adopting EU audit reforms that come into full effect in two months, and discusses transition requirements. These reforms will affect many U.S. companies, especially those with an EU parent or subsidiary that is listed, or has banking or insurance activities.

Go to Defining Issues 16-12 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-12-eu-audit-reforms.pdf

FASB Amends Performance Obligations and Licensing Guidance in Revenue Standard

Defining Issues 16-13 reports that the FASB recently issued an ASU that amends the revenue guidance on identifying performance obligations and accounting for licenses of intellectual property. The ASU changed the FASB's previous proposals on renewals of right-of-use licenses and contractual restrictions.

Go to Defining Issues 16-13 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-13-licensing-revenue-asu-2016-10.pdf

FASB Revenue TRG Discusses Implementation Issues

Defining Issues 16-14 reports that the FASB's Transition Resource Group (TRG) for Revenue Recognition met on April 18, 2016, to discuss implementation issues related to the FASB's revenue topic.

Go to Defining Issues 16-14 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-14-revenue-trg.pdf

SEC Issues Concept Release on Modernizing Regulation S-K

Defining Issues 16-15 reports that the SEC recently published a concept release seeking comments about how to modernize public companies' business and financial disclosures made in periodic reports and registration statements that are required by Regulation S-K. The SEC's review focused on recommendations made in a report mandated by the Jumpstart Our Business Startups Act.

Go to Defining Issues 16-15 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-isssues-16-15-sec-reg-sk.pdf

Revenue Standard Portends Potential Tax Changes

Defining Issues 16-16 reports that the FASB's revenue standard supersedes substantially all existing U.S. GAAP on revenue recognition. Thus, companies may need to change the timing or amount of revenue recognized in their financial statements. These financial reporting changes may affect the calculation and financial reporting for income taxes and other types of taxes.

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

FASB Proposes to Simplify Goodwill Impairment Accounting

Defining Issues 16-18 reports that the FASB is proposing to simplify the subsequent measurement of goodwill by removing Step 2 of the goodwill impairment test.

Go to Defining Issues 16-18 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-18-goodwill-impairment.pdf

FASB Proposal Would Clarify Scope and Application of Revenue Topic

Defining Issues 16-19 reports that the FASB proposed technical corrections and improvements to its revenue topic, and also proposed amendments to other Codification topics to address unintended consequences from applying the revenue topic. Many of the proposed changes address questions raised by the FASB / IASB Joint Transition Resource Group for Revenue Recognition.

Go to Defining Issues 16-19 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-19-revenue-technical.pdf

SEC Staff Warns about Non-GAAP Financial Measures

Defining Issues 16-20 reports that the SEC staff recently updated its guidance about how companies are allowed to use non-GAAP financial measures, and specifically listed prohibited practices. The new guidance follows recent comments by the SEC chair and SEC staff warning that enforcement action will be taken against companies that don't comply with guidance outlining how a company must present non-GAAP financial measures.

Go to Defining Issues 16-20 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-20-sec-non-gaap-finan-measures.pdf

FASB Proposes to Clarify Scope of Derecognition of Nonfinancial Assets

Defining Issues 16-21 reports that a FASB proposal would clarify the scope of its guidance about derecognizing nonfinancial assets and would address the accounting for partial sales of nonfinancial assets.

Go to Defining Issues 16-21 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-21-clarify-scope-derecognition.pdf

EITF Reaches Final Consensus on Statement of Cash Flows Issues

Defining Issues 16-22 reports that the FASB's Emerging Issues Task Force (EITF) reached a final consensus on statement of cash flows issues and a consensus-for-exposure on employee benefit plan master trust reporting issues at its June 10, 2016 meeting.

Go to Defining Issues 16-22 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-22-eitf-cash-flows.pdf

FASB Accelerates Recognition of Credit Losses

Defining Issues 16-23 reports that the FASB's new credit impairment standard will significantly change the way entities recognize impairment of financial assets by requiring immediate recognition of estimated credit losses expected to occur over the remaining life of many financial assets. Entities may need to collect more data and make significant changes to their systems, processes, and internal controls to comply with the requirements of the standard.

Go to Defining Issues 16-23 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-23-credit-impairment.pdf

FASB Proposes Targeted Change to VIE Primary Beneficiary Test

Defining Issues 16-25 reports that, in evaluating whether it is the primary beneficiary, the FASB proposed that a single decision maker or service provider would consider indirect interests held through related parties under common control on a proportionate basis.

Go to Defining Issues 16-25 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-25-vie-beneficiary.pdf

SEC Proposes Raising Limit to Qualify as a Smaller Reporting Company

Defining Issues 16-26 reports that the SEC proposed rules that would make it easier for smaller companies to qualify for reduced reporting requirements that currently are only available to companies with a public float below $75 million.

Go to Defining Issues 16-26 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-26-sec-smaller-company.pdf

SEC Proposes to Eliminate Redundant Disclosures

Defining Issues 16-27 reports that the SEC recently proposed rules that would eliminate redundant and outdated disclosure requirements as part of its disclosure effectiveness initiative.

Go to Defining Issues 16-27 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-27-sec-redundant-disclosures.pdf

FASB Proposes Revamped Income Tax Disclosures

Defining Issues 16-28 reports that, as part of its broader disclosure framework project, the FASB recently proposed improvements to disclosures about income taxes to test the effectiveness of its proposed framework.

Go to Defining Issues 16-28 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2016/defining-issues-16-28-fasb-tax-disclosures.pdf

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

KPMG

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.

July 2016

Tennessee: Proposed rule would adopt economic nexus standard for sales and use Tax

Tennessee appears to be the next state seeking to jump-start litigation over the physical presence nexus standard articulated in the 1992 Quillcase. Similar to a regulation adopted earlier this year in Alabama, the Tennessee Department of Revenue has proposed a rule adopting an economic nexus standard for sales and use tax purposes. If the rule is promulgated as proposed, out-of-state dealers that engage in the regular or systematic solicitation of consumers in Tennessee through any means and make sales exceeding $500,000 to Tennessee consumers during the calendar year would be considered to have substantial nexus with the state. These dealers would be required to register with the state by January 1, 2017 and would have to begin to collect and remit sales tax by July 1, 2017. A hearing on the proposed rule will be held on August 8, 2016, and comments may be submitted to the Department at any time prior to the hearing. Please stay tuned to TWIST (http://www.kpmg-institutes.com/institutes/taxwatch/events/podcast-series/twist-series.html) for future updates on the proposed rule.

IRS practice unit: Corporate inversions

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. The newly released practice unit concerns corporate inversions

As the practice unit explains, corporate inversions may be accomplished in a variety of ways. For example, an inversion may occur in a simple exchange of domestic target stock for new foreign parent acquiring stock, a merger of a domestic corporation into a foreign parent, or a transaction involving both domestic and foreign target stock being acquired by a new foreign parent. Section 7874 was enacted to address corporate inversions, and contains provisions aimed at reducing the incentives for entering into inversions by U.S. multinational companies moving out of U.S. taxing jurisdiction. The practice unit notes that many inversions may not be captured by section 7874 if structured in a manner that limits the ownership of new foreign parent by former shareholders of the domestic target.

The practice unit (release date of July 5, 2016) is available on the IRS practice unit * webpage.

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* The IRS practice units 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.

Thus, 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.

June 2016

Final regulations: Country-by-country reporting

The Treasury Department and IRS today released for publication in the Federal Register final regulations (T.D. 9773)—Reg. section 1.6038-4—requiring annual country-by-country (CbC) reporting by certain U.S. persons that are the ultimate parent entity of a multinational enterprise group that has annual revenue for the preceding annual accounting period of $850 million or more.

The final regulations are effective 30 June 2016 (the date of publication of the regulations in the Federal Register). Today's release finalizes regulations that were proposed in proposed form in December 2015. The final regulations were issued following a public hearing and receipt of comments. After consideration of the comments, the proposed regulations are adopted as amended by today's Treasury decision.

Final regulations

The preamble to the final regulations examines comments received in response to the proposed regulations and explains why certain comments were—or were not—adopted. For instance, comments that CbC reporting would result in high compliance costs for multinational enterprises (MNEs) and would result in the disclosure of sensitive information were rejected. Today's final regulations amend the proposed regulations to reflect the official number of the required form —Form 8975, Country-by- Country Report.

Entities

With regards to entities required to file CbC reports, the final regulations do not modify the definition of constituent entity in the proposed regulations, making it clear that reporting is not required for foreign corporations or foreign partnership for which the ultimate parent entity is not required furnish information under section 6038(a).

The final regulations do, however, modify the reference to a permanent establishment in the definition of business entity for greater clarity and consistency with the intended meaning of the BEPS final report. Accordingly, the final regulations provide that the term permanent establishment includes:

- A branch or business establishment of a constituent entity in a tax jurisdiction that is treated as a permanent establishment under an income tax convention to which that tax jurisdiction is a party
- A branch or business establishment of a constituent entity that is liable to tax in the tax jurisdiction in which it is located pursuant to the domestic law of such tax jurisdiction
- A branch or business establishment of a constituent entity that is treated in the same manner for tax purposes as an entity separate from its owner by the owner's tax jurisdiction of residence.

The final regulations also exclude from the definition of "business entity," decedents' estates, individuals' bankruptcy estates, and grantor trusts within the meaning of section 671, when all the owners are individuals.

In response to a comment, the final regulations expressly provide that foreign insurance companies that elect to be treated as domestic corporations under section 953(d) are U.S. business entities that have their tax jurisdiction of residence in the United States.

Effective date, filing requirements

As noted in the preamble, other countries have adopted CbC reporting requirements for annual accounting periods beginning on or after January 1, 2016, that would require reporting of CbC information by constituent entities of MNE groups with an ultimate parent entity resident in a tax jurisdiction that does not have a CbC reporting requirement for the same annual accounting period. While the final regulations are not applicable for tax years of ultimate parent entities beginning before June 30, 2016 (i.e., the date of publication of the final regulations in the Federal Register), the IRS and Treasury intend to allow ultimate parent entities of U.S. MNE groups and U.S. business entities designated by a U.S. territory ultimate parent entity to file CbC reports for reporting periods that begin on or after January 1, 2016, but before the applicability date of the final regulations, under a procedure to be provided in separate, forthcoming guidance. In general, Form 8975 must be filed with the ultimate parent entity's income tax return for the tax year in or with which the reporting period ends. Furthermore, the preamble indicates that penalty rules under section 6038 apply to Form 8975, including reasonable cause relief for failure to file.

KPMG observation

In a related development today, the OECD announced the release of guidance on the implementation of CbC reporting. The OECD guidance sets out: (1) transitional filing options for MNEs that voluntarily file in the "parent jurisdiction;" (2) guidance on the application of CbC reporting to investment funds; (3) guidance on the application of CbC reporting to partnerships; and (4) the impact of exchange rate fluctuations on the 750 million filing threshold for MNE groups.

Michigan: Pass-through entity withholding eliminated for tax years beginning after July 1, 2016

Beginning next year, pass-through entities will no longer be required to withhold Michigan income taxes. House Bill 5131, which was signed into law on June 8, 2016, eliminates the requirement for pass-through entities (such as S corporations, partnerships, limited partnerships, limited liability partnerships, and limited liability companies) to withhold taxes effective for tax years that begin on or after July 1, 2016.

Most partnerships will be subject to withholding for the entire 2016 tax year. Specifically, for tax years that began before July 1, 2016, pass-through entities generally must continue to withhold tax at the rate of 4.25 percent for each nonresident individual partner and 6.0 percent for each partner that is a corporation or pass-through entity.

Scholarships for nonresident aliens; transfers of property to foreign corporation

The IRS Large Business and International (LB&I) division today publicly released two practice units—as 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. The two practice units released today concern the tax treatment of scholarships and fellowship grants paid to nonresident aliens and situations when a Form 926 is not filed on the transfer of property to a foreign corporation.

The topics of the practice units released today are:

- Taxation of scholarships and fellowship grants paid to a nonresident alien
- Failure to file the Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation—monetary penalty

The practice units (release date of June 14, 2016) are available on the IRS practice unit * webpage.

Canada: CRA to treat certain U.S. LLPs as corporations

Officials from the Canada Revenue Agency (CRA)—speaking at an annual conference of the Canadian branch of the International Fiscal Association (IFA) in late May 2016—commented on the proper classification of limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) governed by the laws of Florida and Delaware and said that these entities are to be treated as corporations for Canadian tax purposes.

The CRA has indicated that written responses to the questions posed at the conference would be available soon.

Background

At last year's conference, the CRA confirmed that it still follows a "two-step approach" to entity classification, and reported it was in the process of considering the proper classification of limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) governed by the laws of Florida, but that it had not yet concluded its analysis. At a November 2015 conference of the Canadian Tax Foundation, the CRA said that it had still not concluded its analysis in this regard, but that it was leaning toward treating them as corporations. It also stated that its analysis had been broadened to include LLPs and LLLPs governed by the laws of Delaware.

Florida, Delaware entities

Speaking at the May 2016 conference, the CRA officials said that only three submissions had been received on this topic, a low level of response to the request for input. The two main factors that the CRA looked at—in arriving at the position on the classification of these entities under both Delaware and Florida partnership law—were the entities' legal personality and the fact that the entities provide limited liability protection to members, much like corporations. Accordingly, as the CRA officials stated, LLPs and LLLPs formed under Delaware and Florida partnership law are to be treated as corporations for Canadian tax purposes. The CRA essentially equates these entities to LLCs.

However, the CRA officials acknowledged that this treatment could create problems for groups that include these entities, and agreed to provide some administrative concessions. If the following conditions are met, absent any tax avoidance, these entities could be converted into some other form of partnership without triggering any adverse Canadian tax implications:

- The entity must have been formed, and must carry on business, prior to July 2016.
- The members must have formed the entity in order to carry on business in common, with a view to profit (the statutory definition of a partnership).
- The members must have intended the entity to be treated as a partnership, from the time of its formation, for Canadian tax purposes.
- Neither the entity nor any of its members have taken the position that the entity is not a partnership.
- The entity must be converted into some other form of partnership recognized by the CRA as a partnership prior to 2018.

The CRA officials also stated that this relief would not apply to an LLC or a U.S. C corporation that is converted to an LLP or an LLLP prior to July 2016. In this situation, there would not be a significant change to the treatment of the entity from a Canadian perspective (it would go from being treated as a corporation to being treated as a corporation); and therefore, no relief would be granted.

IRS practice units on FDAP payments

The IRS Large Business and International (LB&I) division today publicly released two practice units—as 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. The two practice units today concern the treatment of "fixed or determinable annual or periodical" (FDAP) payments.

Specifically, the topics of the practice units are:

- FDAP payments – source of income
- FDAP withholding under chapter 3

The practice units (release date of June 2, 2016) are available on the IRS practice unit * webpage.

* The IRS practice units 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.

Thus, taxpayers (and their tax advisers) facing an IRS examination or concerned with issue(s) presented by these 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.

May 2016

Rev. Proc. 2016-30: "Pre-filing agreement" update, increased user fee

The IRS today released an advance version of Rev. Proc. 2016-30 that updates the rules and procedures for taxpayers seeking an IRS examination and resolution of certain specific issues relating to tax returns before the returns are actually filed. If the IRS and the taxpayer reach an agreement on the issues, a "pre-filing agreement" (PFA) may be executed.

Rev. Proc. 2016-30 modifies the rules and process for PFAs that are available to taxpayers under the jurisdiction of the IRS Large Business and International (LB&I) division.

Increased user fee

The user fee under the PFA program is set to increase from $50,000 to:

- $134,300 for requests submitted on or after June 3, 2016
- $218,600 for requests submitted on or after January 1, 2017

A fee is assessed for each separate and distinct issue examined under Rev. Proc. 2016-30.

Background

Rev. Proc. 2009-14 made the then-existing pre-filing agreement (PFA) program permanent, and outlined the procedures for eligible taxpayers to request that the IRS examine specific issues relating to tax returns before those returns are filed. Under the PFA program established by Rev. Proc. 2009-14, if an agreement resolving the examined issues was reached before the returns were filed, the agreement was memorialized by executing a pre-filing agreement that was valid for the current tax year and up to four subsequent tax years.

Unlike letter rulings and other forms of written advice provided by the IRS Offices of the Associates Chief Counsel, a PFA does not determine the tax treatment of prospective or future transactions or events, but only of completed transactions or events whose tax treatment has not yet been reported on a return.

Rev. Proc. 2009-14 established the procedures: (1) for requesting consideration of issues under the PFA program, (2) how taxpayer issues would be selected under the PFA program; and (3) how the requests would be administered. It also described the effects of an agreement under the PFA program as well as the user fee information.

Rev. Proc. 2016-30

Today's revenue procedure:

- Clarifies and updates the procedures for filing a PFA request
- Expands the scope of a PFA to include issues related to changes in methods of accounting requested under the automatic change procedures
- Increases the user fee for requests submitted on or after June 3, 2016

Like the 2009 revenue procedure, Rev. Proc. 2016-30 explains that the PFA system is available to taxpayers under LB&I jurisdiction, applies to the current tax year or any prior tax year for which the original tax return is not yet due and is not yet filed, and limits PFAs for future tax years to four tax years beyond the current tax year.

Rev. Proc. 2016-30 lists issues that generally are eligible for consideration under the PFA program, and also lists issues that are not eligible for PFA treatment (excluded domestic and international issues include transfer pricing issues and issues involving the accounting period, among others).

The revenue procedure sets out what is required information for a PFA request—including the specific description(s) of the issue(s)—and the instructions for where and how to submit the request. There is guidance provided as to how the IRS would select a taxpayer for the PFA program and the criteria for selection, the manner in which a PFA would be processed, and the nature and effect of a PFA, including its form and content.

At any time before a PFA is executed, either the taxpayer or the IRS may withdraw (all or parts) of the request for a PFA. If no agreement is reached, no PFA is executed, but the taxpayer and the IRS may seek to apply post-filing procedures such as the "accelerated issue resolution" (AIR) procedures to reach an agreement.

KPMG observation

Tax professionals have found the PFA program to be successful—from the perspective of both taxpayers and the IRS—in that the PFA program improves the quality of tax compliance while at the same time reduces costs and other burdens related to tax administration. The increased user fees, however, could be viewed as another hurdle for taxpayers proactively seeking to improve compliance and obtain certainty regarding eligible issues. For those taxpayers contemplating using the PFA program to resolve a current issue, consider submitting a PFA request prior to June 3, 2016, given the user fee increase set to go into effect at that date.

Proposed regulations: Reporting obligations of foreign -owned disregarded entity

The Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-127199-15) that would treat a domestic disregarded entity that is wholly owned by a foreign person as a domestic corporation for the limited purposes of the reporting and recordkeeping requirements under section 6038A.

The proposed regulations provide that these domestic disregarded entities—that would be deemed to be foreign-owned domestic corporations—would be required:

- To file Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engage in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code), and identify an expanded number of "reportable transactions" between the entity and its foreign owner or other foreign related parties
- To maintain records establishing the accuracy of the information return and the correct U.S. tax treatment of the transactions
- To obtain an employer identification number (EIN) by filing Form SS-4, and thus would be required to report responsible party information to the U.S. government

The Treasury Department, in a related release, included the following statement about the proposed regulations:

> … there is a narrow class of foreign-owned U.S. entities—typically single member LLCs—that have no obligation to report information to the IRS or to get a tax identification number. These "disregarded entities" can be used to shield the foreign owners of non-U.S. assets or non-U.S. bank accounts. Once these regulations are finalized, they will allow the IRS to determine whether there is any tax liability, and if so, how much, and to share information with other tax authorities. This will strengthen the IRS's ability to prevent the use of these entities for tax avoidance purposes, and will build on the success of other efforts to curb the use of foreign entities and accounts to evade U.S. tax.

New reporting requirements

As stated in the preamble, the proposed regulations are intended to provide the IRS with improved access to information needed to satisfy obligations under income tax treaties, information exchange agreements, and other international agreements—and to strengthen the enforcement of U.S. tax laws. The proposed regulations would amend the definition of business entities in Reg. section 301.7701-2, and would amend Reg. section 1.6038A-1 and -2.

The proposed regulations also would add a requirement to report related-party transactions under the transfer pricing provisions of the regulations under section 482, if not already covered by another reportable category, and would require reporting of transactions that otherwise would be disregarded for U.S. tax purposes—such as transactions between a disregarded entity and its owner. Thus, today's proposed regulations expand the term "reportable transaction" to also include contributions and distributions between the entity and its foreign owner (or another disregarded entity of the same owner).

Existing exceptions to the section 6038A reporting requirements for small corporations and de minimis transactions would not apply to disregarded domestic entities that are deemed to be domestic corporations under the proposed amendments to Reg. section 301.7701-2.

The preamble indicates that the proposed regulations would impose a filing obligation on a foreign-owned disregarded domestic entity for reportable transactions it engages in even if its foreign owner already has an obligation to report the income resulting from those transactions—for example, transactions resulting in income effectively connected with the conduct of a U.S. trade or business.

The preamble to the proposed regulations also announced that the IRS is considering modifications to corporate, partnership, and other tax or information returns (or their instructions) to require the filer of these returns to identify all the foreign and domestic disregarded entities it owns.

Comments requested

The IRS and Treasury specifically have requested comments concerning a filing obligation imposed on a foreign-owned disregarded entity for reportable transactions when the foreign owner has already an obligation to report the income from those transactions—for example, transactions resulting in income that is effectively connected with the conduct of a U.S. trade or business. Comments and requests for a public hearing must be received by a date that is 90 days after Tuesday, May 10, 2016 (the scheduled date of publication of the proposed regulations in the Federal Register.

Proposed effective date

These regulations are proposed to be effective for tax years ending on or after the date that is 12 months after the date when these regulations are published as final regulations in the Federal Register.

KPMG observation

The proposed regulations do not appear to specifically address issues such as the name, address, tax year, and accounting methods to be used by the disregarded domestic entity that would be deemed to be a domestic corporation for purposes of section 6038A, and do not address procedural filing related issues such as a requirement to file a Form 1120, and the identity of the person against which actions would be taken for failures to file and related failures.

The proposed regulations apparently would not deem a U.S. branch of a foreign corporation to be a foreign owned U.S. corporation if that U.S. branch is not organized as an entity for purposes of Reg. section 301.7701-2.

IRS practice unit, taxpayer's affirmative use of section 482

The IRS Large Business and International (LB&I) division today publicly released a practice unit—"Taxpayer's affirmative use of IRC section 482"—that is 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.

Text of the practice unit (release date of 12 May 2016) is available on the IRS practice unit * webpage.

This practice unit explains that section 482 allows the IRS to make allocations so that taxpayers clearly reflect income attributable to controlled transactions and to prevent the evasion of taxes. In general, section 482 can only be used by the IRS, but taxpayers are allowed to invoke section 482 under certain situations:

- On a timely filed U.S. income tax return, the taxpayer is reporting the results of a transaction that are different than the actual prices charged, but is doing so to clearly reflect an arm's length result.
- In appropriate circumstances, the IRS may permit amended returns that increase taxable income if the results are otherwise arm's length.
- A taxpayer can request a setoff when the IRS proposes a section 482 allocation. The setoff transactions must be between the taxpayer and the same controlled party involved in the proposed section 482 adjustment, be in the same tax year, and follow certain procedural requirements.

The practice unit explains that taxpayers are not allowed to file an untimely or amended return that decreases U.S. taxable income based on allocations with respect to controlled transactions.

Connecticut: Budget implementer bill includes market-based sourcing for corporation business and individual income tax

Under legislation enacted last year, effective for tax years beginning on or after January 1, 2016, most Connecticut corporate taxpayers are required to apportion their income to Connecticut using single-sales factor apportionment. Senate Bill 502, the budget implementer bill, which has been agreed to by the House and Senate, adopts market-based sourcing provisions. Under current law, the Connecticut sales factor numerator includes "receipts from services performed within the state, rental and royalties from properties situated within the state, royalties from the use of patents or copyrights within the state, interest managed or controlled within the state, net gains from the sale or other disposition of intangible assets managed or controlled within the state, net gains from the sale or other disposition of tangible assets situated within the state, and all other receipts earned within the state."

Under the new market-based sourcing rules, gross receipts from services will be assigned to Connecticut if and to the extent the market for the service is in the state. Other new rules address different categories of receipts. Specifically, gross receipts from the rental, lease or license of real or tangible personal property will be assigned to Connecticut to the extent the property is situated within the state. Gross receipts from the rental, lease or license of intangible property will be assigned to Connecticut if and to the extent the property is used in the state. Intangible property utilized in marketing a good or service to a consumer will be considered used in Connecticut if the good or service is purchased by a consumer in this state. Gross receipts from interest managed or controlled within Connecticut will continue to be assigned to the sales factor numerator, as under existing law. All gross receipts not specifically addressed will be attributed to Connecticut to the extent the taxpayer's market for the sale is in the state.

There is a complete exclusion from the sales factor for gross receipts from the sale or other disposition of real property, tangible personal property, or intangible property if such property is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

A taxpayer that cannot reasonably assign its receipts under the revised law may petition the Commissioner for approval to use a methodology that reasonably approximates the assignment of such receipts. Any such petition must be submitted no later than sixty days prior to the original (i.e., non-extended) due date of the return for the first income year to which the petition applies. The Commissioner must grant or deny the petition before the due date of the return.

In addition to adopting market-based sourcing provisions for Corporation Business Tax purposes, Senate Bill 502 adopts similar market-based sourcing rules and single-sales factor apportionment for individual income tax purposes. These provisions are effective for tax years beginning on or after January 1, 2017.

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* The IRS practice units 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.

Thus, taxpayers (and their tax advisers) facing an IRS examination or concerned with issue(s) presented by these 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.

Puerto Rico: VAT regime repeal is upheld by veto-override

The legislature of Puerto Rico has voted to override the governor's veto of a bill to repeal the value added tax (VAT) regime that was scheduled to be effective beginning June 2016. Thus, the commonwealth's existing sales and use tax system (known as "IVU") will continue to apply.

The governor on Friday, May 20, vetoed a bill to repeal the VAT system. The Puerto Rico Senate today, following a vote by the House of Representatives of Puerto Rico earlier this week, voted to override the governor's veto—votes in both houses that reached the required two-thirds majority to override the veto.

Background

Puerto Rico Act No. 72 (May 29, 2015) replaced the commonwealth sales and use tax with a new VAT, imposed at a rate of 10.5%. Originally, the VAT regime was to be effective in April 2015, but the VAT law included a measure providing that the Puerto Rico Treasury Secretary could postpone application of the VAT provisions for a specific period of time. The effective date of the VAT system was initially postponed until April 1, 2016, and then again until June 1, 2016.

With this week's action by the legislature, the VAT regime has been repealed, and the Puerto Rico sales and use tax system will continue to apply.

KPMG observation

It is expected that the Puerto Rico Treasury Department will issue guidance to clarify the effect of this week's veto-override and the continuation of the sales and use tax system.

Arkansas: Manufacturing exemption did not apply to purchases of water treatment equipment

The Arkansas Supreme Court recently addressed whether equipment used to expand a water-treatment plant was exempt from sales and use tax. The water treatment plant utilized an extensive three-phase process to convert surface water into potable drinking water. During each phase, chemicals were used to purify and clarify the water. The taxpayer claimed that certain purchases of tangible personal property —piping used to carry the chemicals and concrete holding tanks— were exempt from sales and use tax as items used to expand a manufacturing facility. On audit, the Arkansas Department of Finance and Administration assessed use tax on the taxpayer's equipment purchases on the basis that the taxpayer did not qualify for the manufacturing exemption. In the Department's view, the water-treatment plant cleaned, but did not manufacture the water. After a circuit court ruled in favor of the taxpayer on the basis that the "extensive mechanical and chemical treatment process turned a raw material into a finished product," the Department timely appealed the issue to the Arkansas Supreme Court.

Under Arkansas law, equipment and machinery used directly in manufacturing is exempt from sales and use taxes. "Manufacturing" means those operations commonly understood to be manufacturing under the ordinary meaning of the term. In determining whether the water-treatment process constituted manufacturing, the court looked to several prior Arkansas cases. Under these decisions, manufacturing generally involved some kind of change or transformation, and required more than merely putting raw materials into a marketable form. In one case, the court held that combining water, sugar, cola concentrate and other ingredients to make a bottled cola beverage constituted manufacturing for purpose of the Arkansas manufacturing exemption. The court distinguished this case from the taxpayer's water treatment process because in the soda context raw materials were transformed into a new product. The water treatment plant, in contrast, did not manufacture or process a new product. As the court observed, "it was water in the beginning, and it was water in the end." As a result, the court held that the taxpayer was not entitled to claim the manufacturing exemption for equipment used at the water-treatment plant. Two justices dissented. In their view, treating the water was indistinguishable from manufacturing soda because the treatment involved the injection of numerous chemicals into the water and transformed non-consumable water into consumable water.

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Payroll Update

Final Overtime Rule from the Department of Labor

The Federal Department of Labor (DOL) finalized a rule (Final Rule) on May 18, 2016 involving a new white collar exemption threshold of $47,476 a year for employees who currently work in positions and perform duties meeting any of the three white collar exemption classifications (Executive, Administrative, Professional). This is more than double the current level of $23,660 a year which has remained unchanged for over 10 years, with the last update occurring in 2004.

When an employee is classified as white collar exempt (exempt), it means the employee is paid on a salary basis of at least $23,660 per year ($455/week), and duties they perform meet the duties test, therefore exempting the employer from being required to pay them overtime for all hours worked over 40 in a given work week.

This change will affect any employee currently classified as exempt earning a salary between $23,660 and $47,475 per year. The employer will need to make a decision as to increasing the employee's salary to $47,476 per year or change their classification to non-exempt and begin paying the employee overtime for all hours worked over 40 in a given work week. (Note: State laws still apply and employers should also monitor state laws to ensure compliance if the state law is more beneficial than the Federal DOL laws.)

The announcement was made by President Obama and Labor Secretary Perez on May 18, 2016. This announcement means that full-time employees earning up to the new $47,476 threshold a year will be eligible for overtime pay. The Final Rule also allows for future increases every three years beginning January 1, 2020 based on wage growth over time. Over 270,000 comments were considered by the DOL in drafting this rule.

The DOL estimated the new threshold rule will directly impact approximately 4.2 million workers who are currently not eligible for overtime, by forcing either a compensation increase or allowing for overtime amounts to be paid. The Final Rule will also indirectly impact 8.9 million workers (3.2 million blue collar and 5.7 million white collar workers) who are currently overtime-eligible but whose salaries are above the existing threshold. These are workers whose duties do not meet the exemption for executive, administrative or professional workers - but under the Final Rule, they will be overtime-eligible as their salaries will fall below the new threshold and no "duties test" assessment is needed.

The effective date of the Final Rule is December 1, 2016. The primary focus of the Final Rule is updating the salary and compensation levels needed for Executive, Administrative and Professional workers to be exempt from overtime. The Final Rule:

1. Sets the standard salary level at the 40th percentile of earnings of full-time salaried workers in the lowest-wage Census Region, currently the South ($913 per week; $47,476 annually for a full-year worker). This means that 35% of full-time salaried workers will be automatically entitled to overtime pay based on their salary.
2. Sets the total annual compensation requirement for highly compensated employees subject to a minimal duties test to the annual equivalent of the 90th percentile of full-time salaried workers nationally to $134,004 (from the current $100,000); and
3. Establishes a mechanism for automatically updating the salary and compensation levels every three years to maintain the levels at the above percentiles and to ensure that they continue to provide useful and effective tests for exemption.

In addition, the Fact Sheet (https://www.dol.gov/whd/overtime/final2016/overtime-factsheet.htm) provided by the DOL will allow employers to use bonus payments to account for as much as 10% of the new $47,476 annual salary amount. Currently, employers are not allowed to use bonus payments for the existing threshold of $23,660. These payments are comprised of non-discretionary bonuses, incentive pay and commissions, provided these payments are made on at least a quarterly basis.

Note that the Final Rule does not change the "duties test" (to ensure the work the employee is performing meets the rules Congress meant to exclude from overtime protections) nor the "salary basis test" (if the salary is above the threshold) to determine which employees are exempted from overtime pay. Thus, white collar salaried workers earning above the new salary threshold are still subject to the "duties test" in determining if they are eligible or ineligible for overtime pay.

The Fact Sheet also indicated the DOL will issue three technical guidance memos to assist private employers, nonprofit employers and i nstitutions of higher education on complying with the Final Rule.

The Overtime Overview (https://www.dol.gov/sites/default/files/overtime-overview.pdf) document from the DOL stated that the Final Rule was a

response to the overtime exemption of certain white collar workers: "The passage of the Fair Labor Standards Act gave most Americans the right to a minimum wage and time-and-a-half pay for more than 40 hours of work in a week. These rules apply to most hourly and salaried workers, but not to some white collar workers whose salaries and duties exempt them from the overtime pay requirement. ... The rule will entitle most salaried white collar workers earning less than $913 a week ($47,476 a year) to overtime pay. This long-awaited update will provide a meaningful boost to workers, and it will go a long way toward realizing President Obama's commitment to ensuring every worker is compensated fairly for their hard work."

The Overtime Overview document also stated that the Final Rule is intended to put more money into the pockets of middle class workers (approximately an extra $1.2B a year) as employers may increase salaries to the new threshold or pay overtime premium for hours over 40 per week. It can also lead to employees working only 40 hours per week, thus giving them more free time for personal or family pursuits (work-life balance).

As mentioned earlier, this should also lead to more clarity for employees and employers vis-à-vis the overtime exemption since the employees' salaries are below the new threshold, then the employers do not need to find out if they pass the "duties test" to be overtime eligible. Lastly, the Final Rule is intended to increase employment as some employers may find it more productive and economical to hire additional workers for the work to be done during overtime hours.

Given that the effective date of this new legislation is not until December 1, 2016, employers should have ample time to analyze their current employee population and make informed decisions as to whether they will increase employees' salaries to maintain their white collar exempt status or maintain the employees' current salaries and change their classification to non-exempt and begin paying the employee overtime when warranted. Employers should also review the various states they have employees in to determine whether federal or state laws apply.

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