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Jnet newsletter

U.S. business update for Japanese companies

Issue 1 - 2018

ENGLISH EDITION

KPMG's U.S. Japanese Practice

Contents

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Published since 1997, Jnet is issued quarterly to update you on audit, accounting, tax, and other business issues relevant to Japanese companies operating in the United States.

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2018 Priorities for Boards and Audit Committees

On the 2018 Board Agenda

Board agendas should continue to evolve in 2018—the game-changing implications of technology/digital innovation, scrutiny of corporate culture and leadership, growing demands for companies to address environmental and social issues, and investor expectations for greater board engagement and diversity and long-term corporate performance will all drive a sharper focus on positioning the company for the future. Combined with a slow-growth economy, uncertainty around tax, trade, and infrastructure policies, and geopolitical tensions at precarious levels, the year ahead will require a careful balance of near-term focus, agility, and long-term thinking.

Drawing on insights from our work and interactions with directors and business leaders over the past 12 months, we've highlighted six items for boards to consider as they focus on their 2018 agendas—on the critical challenges at-hand and on the road ahead.

- Help the company keep focused on long-term performance.
- Expect disruption to continue full-force with technology and "digital" at its core.
- Be sensitive to risks posed by the tone at the top and organizational culture.
- Learn to live with cyber risk and refine boardroom discussions about cyber risk and security.
- Promote effective shareholder engagement, including engagement with activists.
- Focus on building a board that is designed to align with a company's future needs—recognizing that diversity and healthy turnover are key.

On the 2018 Audit Committee Agenda

Financial reporting, compliance, and the risk and internal control environment will continue to be put to the test in 2018—by slow growth and economic uncertainty, technology advances and business model disruption, cyber risk, greater regulatory scrutiny and investor demands for transparency, as well as dramatic political swings and policy changes in the U.S., UK, and elsewhere. Focused, yet flexible agendas—exercising judgment about what does and does not belong on the committee's agenda, and when to take deep dives—will be critical.

Drawing on insights from our recent survey work and interactions with audit committees and business leaders over the past 12 months, we've highlighted seven items that audit committees should keep in mind as they consider and carry out their 2018 agendas.

- Stay focused on job No. 1 – financial reporting integrity.
- Financial reporting quality starts with the CFO and the finance organization; maintain a sharp focus on leadership and bench strength.
- Monitor management's progress on implementing FASB's revenue standard and other accounting changes on the horizon, and stay apprised of tax legislative and regulatory developments.
- Focus internal audit on the company's key risks, beyond financial reporting and compliance.
- Reinforce audit quality and transparency.
- Monitor the impact of the business and regulatory environment, as well as tone at the top and corporate culture, on the company's compliance programs.
- Make the most of the audit committee's time together—effectiveness requires efficiency.

For more information, download the full report below.

Download Now

On The 2018 Board Agenda > (PDF/153KB)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/02/us-jnet-2018-issue1-1-1-KPMG-on-the-2018-board-agenda.pdf

On The 2018 Private Board Agenda > (PDF/259KB)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/02/us-jnet-2018-issue1-1-2-KPMG-on-the-2018-private-company-board-agenda.pdf

On The 2018 Audit Committee Agenda > (PDF/121KB)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/02/us-jnet-2018-issue1-1-3-KPMG-on-the-2018-audit-committee-agenda.pdf

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Digital Transformation

How advanced technologies are impacting financial reporting and auditing

Foreword

The world is in the midst of a digital transformation that is changing the ways we work and live. Hundreds of millions of data points are shared every minute on the worldwide web alone, and billions upon billions more are shared within and between organizations around the globe. Yet 81% of CEOs believe that their organizations are not keeping up with the emergence of technologies that could help them make more informed decisions and run their businesses better. [1]

To learn how "must-have" advanced technologies are impacting financial reporting and external audit, KPMG, in collaboration with Forbes Insights, conducted a survey of CFOs, controllers and other financial executives in April 2017. We were specifically interested in knowing how organizations are dealing with the digital revolution and their plans for moving forward.

We found that virtually all (99%) of organizations believe that advanced technology can enhance external audit and 89% are using the cloud for financial reporting. However, we also found that many organizations have a long way to go, with only 26% saying advanced technologies are a "must-have" within the next one to two years.

This report, "Digital Transformation: How Advanced Technologies Are Impacting Financial Reporting and Auditing," details the key findings from this research and also includes commentary from senior executives who are experiencing these changes firsthand. As you review this report, you will learn what is top-of-mind with financial executives today and how they plan to leverage "must-have" advanced new technologies in the future.

We hope you find this report informative and thought-provoking.

Shaun Budnik
US Audit Innovation Leader
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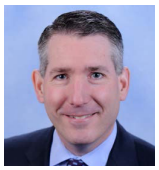

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[1] *https://www.forbes.com/forbesinsights/kpmg_ceo_global_2016/index.html*

Introduction

The explosion of data and unprecedented advances in computer processing power have dramatically increased the capacity to support decision making across multiple operations. The world has moved well beyond basic and enhanced process automation and is entering an era of cognitive automation. Some are calling this the "Fourth Industrial Revolution." The impact of advanced technologies touches virtually every industry and organization on many levels, from strategic planning and marketing to supply chain management and customer service. Financial reporting and external audit are no exceptions.

As Isabel Witte, vice president and controller of Siemens Healthcare Diagnostics North America, puts it: "Technology is becoming more and more important to financial reporting and audit. But it is really much bigger than that. Beyond financial reporting, technology is an enhancement for identifying market trends, process improvement and other metrics that help us run our business and serve our customers better."

To learn more about the role of technology in financial reporting, Forbes Insights and KPMG surveyed 261 senior financial executives. We found that regardless of industry, organization size or geographic location, advanced technology is playing an increasing role in corporate financial reporting and external audit.

Although some organizations are moving at a faster pace than others, the vast majority agree that enhancing their technological capabilities in the financial function is a priority now and in the future. Twenty-six percent say that advanced technologies will be a "must have" capability for their organization in the next one to two years, and 55% say advanced technology will be a "must have" in three to five years. Given the speed of technological advancements, the latter may need to reconsider their sense of urgency on this issue.

This report analyzes areas in which organizations excel in adopting advanced technologies and where there is still room for improvement. It also examines challenges organizations face in introducing new technologies and maintaining data security in a cloud-based world.

Key findings

69% **of respondents rate their organization's use of new technologies as "advanced;" however, given how few organizations use technologies like robotics (38%) and natural language processing (35%), there is a clear disconnect between how companies self-assess and what their companies are doing in reality**

77% **of executives say their finance team is using predictive analytics and 75% are using workflow automation**

36% **cite increased data reliability, predictability and accuracy as the main benefits of advanced technology**

89% **report using the cloud for financial reporting**

36% **report they are concerned about unauthorized use of data**

53% **of executives say advanced technology will be a "must-have" for their organization in three to five years**

99% **of executives believe advanced technology can enhance the external audit**

Questions?

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For more information, download the full report below.

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Digital Transformation > (PDF/1.91MB)
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Auditing & Accounting Update

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

Recent IRS audit rules may affect how partnerships account for tax underpayments

Defining Issue 17-27 reports on what changes partnerships may need to make to their financial reporting beginning in 2018. Recent IRS rules for audits of partnerships may change the accounting for tax underpayments.

Go to Defining Issues 17-27 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2017/defining-issues-17-27-irs-partnerships.pdf

FASB makes presentation and disclosure decisions for long-duration insurance contracts

Defining Issue 17-28 reports on the FASB's decisions about the presentation and revised disclosures for long-duration insurance contracts. These decisions include changes to the frequency and transition requirements.

Go to Defining Issues 17-28 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2017/defininig-issues-17-28-long-insurance-presentation-disclosures.pdf

FASB agrees to further amend the Leases standard

Defining Issue 17-29 reports on decisions made at the November 29, 2017 FASB meeting. The Board decided to finalize its proposed ASU on land easements, and propose practical expedients on transition and the accounting for lease and non-lease components by lessors.

Go to Defining Issues 17-29 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2017/defining-issues-17-29-fasb-agrees-amend-leases.pdf

Adoption of new accounting standards may lead to share-based payment award modifications

Defining Issue 17- 30 reports on accounting implications of changes to share-based payment awards after adoption of a new accounting standard or a voluntary accounting change. If adoption of a new accounting standard or a voluntary accounting change affects operating results or performance metrics, a company may need or want to re-evaluate its performance conditions and the underlying compensation objectives for its share-based payment awards.

Go to Defining Issues 17-30 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2017/di-adopt-new-acct-standards-share-based-payment-award-modif.pdf

Q&A; Tax Reform, Supplement to KPMG's Handbook, Accounting for Income Taxes

Defining Issues 17-31 provides supplement to KPMG's Handbook, Accounting for Income Taxes, which considers the financial reporting implications under US GAAP of H.R. 1, originally known as the Tax Cuts and Jobs Act. KPMG's latest Q&As incorporate disclosure considerations and other new hot topics. We also incorporate guidance from the FASB staff's issued FAQs.

Go to Defining Issues 17-31 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2017/di-tax-reform-enacted.pdf

Tax reform in the United States - IFRS (PDF/417KB) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2018/ifrs-qa-us-tax-reform.pdf

EITF consensus-for-exposure on accounting for implementation costs of cloud computing arrangements

Defining Issues 18-1 reports that the EITF reached a consensus-for-exposure on accounting for implementation costs incurred in a cloud computing arrangement. The FASB's EITF agreed at its January 18, 2018 meeting that implementation costs incurred by customers in cloud computing arrangements should be deferred if those same costs would be capitalized by a customer in a software licensing arrangement.

Go to Defining Issues 18-1 (PDF) >
https://frv.kpmg.us/content/dam/kpmg-frv/pdf/2018/defining-issues-18-1-eitf.pdf

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Questions?
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Tax Update

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

Tax Reform - KPMG Report on New Tax Law

On December 22, 2017, the president signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The new law represents the culmination of a lengthy process in pursuit of business tax reform over the course of more than 20 years.

The legislation includes substantial changes to the taxation of individuals, businesses in all industries, multi-national enterprises, and others. Overall, it provides a net tax reduction of approximately $1.456 trillion over the 10-year "budget window" (according to estimates provided by the Joint Committee on Taxation (JCT) that do not take into account macroeconomic/dynamic effects).

Highlights include:

- A permanent reduction in the statutory C corporation tax rate to 21%, repeal of the corporate alternative minimum tax (AMT), expensing of capital investment, limitation of the deduction for interest expense, and a multitude of other changes to the corporate tax rules.
- Fundamental changes to the taxation of multinational entities, including a shift from a system of worldwide taxation with deferral to a hybrid territorial system, featuring a participation exemption regime with current taxation of certain foreign income, a minimum tax on low-taxed foreign earnings, and new measures to deter base erosion and promote U.S. production.
- Significant changes relevant to the taxation of tax-exempt organizations, insurance businesses, financial institutions, regulated investment companies (RICs), and real estate investment trusts (REITs).
- A temporary new deduction for certain individuals, trusts, and estates with respect to "domestic qualified business income" of passthrough entities and sole proprietorships.
- Temporary reductions in the individual income tax rates, accompanied by new limits on itemized deductions (such as the deduction for state and local taxes), other temporary changes to the individual income tax rules, and a more restrictive permanent cost-of-living bracket adjustment.
- Permanent repeal, in effect, of the individual mandate in the Patient Protection and Affordable Care Act.

This report includes analysis and observations regarding the myriad of tax law changes in H.R. 1. This report also includes discussions of (1) the impact of the new law on various industries (including RICs, REITs, insurance, natural resources, and financial services); (2) potential state and local tax implications of the law changes; and (3) financial accounting considerations.

To read the complete KPMG Report on New Tax Law, please visit www.kpmg.com/us/new-tax-law-book. This is one of a series of reports that KPMG prepared as tax reform legislation moved through various stages of the legislative process. To read KPMG's reports and coverage of subsequent developments, see TaxNewsFlash-Tax Reform and TaxNewsFlash-United States.

Individuals

Ordinary income tax rates – in general

The new law temporary modifies the income rate structure under which individuals are taxed. Under pre-enactment law, there were seven rates: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The new law maintains the seven-rate structure, but taxes a taxpayer's income at modified rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The new rate structure is effective for tax years beginning in 2018, but ceases to apply after December 31, 2025.

Married Filing Joint

2018 Prior Law		New Law	
Tax Rate	**If taxable income is:**	**Tax Rate**	**If taxable income is:**
10%	$0 to $19,050	10%	$0 to $19,050
15%	$19,051 to $77,400	12%	$19,051 to $77,400
25%	$77,401 to $156,150	22%	$77,401 to $165,000
28%	$156,151 to $237,950	24%	$165,001 to $315,000
33%	$237,951 to $424,950	32%	$315,001 to $400,000
35%	$424,951 to $480,050	35%	$400,001 to $600,000
39.6%	$480,051 or more	37%	$600,001 or more

Married Filing Separate

2018 Prior Law		New Law	
Tax Rate	**If taxable income is:**	**Tax Rate**	**If taxable income is:**
10%	$0 to $9,525	10%	$0 to $9,525
15%	$9,526 to $38,700	12%	$9,526 to $38,700
25%	$38,701 to $78,075	22%	$38,701 to $82,500
28%	$78,076 to $118,975	24%	$82,501 to $157,500
33%	$118,976 to $212,475	32%	$157,501 to $200,000
35%	$212,476 to $240,025	35%	$200,001 to $300,000
39.6%	$240,026 or more	37%	$300,001 or more

Head of Household

2018 Prior Law		New Law	
Tax Rate	**If taxable income is:**	**Tax Rate**	**If taxable income is:**
10%	$0 to $13,600	10%	$0 to $13,600
15%	$13,601 to $51,850	12%	$13,601 to $51,800
25%	$51,851 to $133,850	22%	$51,801 to $82,500
28%	$133,851 to $216,700	24%	$82,501 to $157,500
33%	$216,701 to $424,950	32%	$157,501 to $200,000
35%	$424,951 to $453,350	35%	$200,001 to $500,000
39.6%	$453,351 or more	37%	$500,001 or more

Single

2018 Prior Law		New Law	
Tax Rate	**If taxable income is:**	**Tax Rate**	**If taxable income is:**
10%	$0 to $9,525	10%	$0 to $9,525
15%	$9,526 to $38,700	12%	$9,526 to $38,700
25%	$38,701 to $93,700	22%	$38,701 to $82,500
28%	$93,701 to $195,450	24%	$82,501 to $157,500
33%	$195,451 to $424,950	32%	$157,501 to $200,000
35%	$424,951 to $426,700	35%	$200,001 to $500,000
39.6%	$426,701 or more	37%	$500,001 or more

New indexing method

The new law introduces a new method for indexing the tax rate thresholds, standard deduction amounts, and other amounts for inflation.

Standard deductions

The new law significantly increases the standard deduction for all taxpayers for tax years beginning after December 31, 2017. Under pre-enactment law, the standard deduction for 2018 would have been $6,500 for a taxpayer filing as single or married filing separately, $9,550 for a taxpayer filing as head of household, and $13,000 for taxpayers filing as married filing jointly. Under the new law, the standard deduction in 2018 will be $12,000 for a taxpayer filing as single or married filing separately, $18,000 for a taxpayer filing as head of household, and $24,000 for taxpayers filing as married filing jointly (and surviving spouses). These amounts will be adjusted for inflation for tax years beginning after December 31, 2018 and are scheduled to sunset December 31, 2025.

The new law retains the additional standard deduction for the elderly and the blind.

Tax rates on capital gains and dividends

The new law keeps in place the system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, with higher rates for gains from collectibles and unrecaptured depreciation.

The new law also leaves in place the current 3.8% net investment income tax.

Deduction for taxes (including state and local taxes) not paid or accrued in a trade or business

Under the new law, itemized deductions for state and local income taxes, state and local property taxes, and sales taxes are limited to $10,000 in the aggregate (not indexed for inflation)—this cap does not apply if the taxes are incurred in carrying on a trade or business or otherwise incurred for the production of income. In addition, foreign real property taxes, other than those incurred in a trade or business, are not deductible.

The effective date is for tax years beginning after December 31, 2017 and beginning before January 1, 2026.

Suspend and modify deduction for home mortgage interest and home equity debt

Under pre-enactment law, qualified residence interest was allowed as an itemized deduction, subject to limitations. Qualified residence interest included interest paid or accrued on debt incurred in acquiring, constructing, or substantially improving a taxpayer's residence ("acquisition indebtedness") and home equity indebtedness. Interest on qualifying home equity indebtedness was deductible, regardless of how the proceeds of the debt were used, but such interest was not deductible in computing alternative minimum taxable income.

The new law suspends the deduction for interest on home equity indebtedness for tax years 2018 through 2025.

For the same tax years, the new law limits the deduction available for mortgage interest by reducing the amount of debt that can be treated as acquisition indebtedness from the prior level of $1 million to $750,000.

Debt incurred before December 15, 2017, is not affected by the reduction and is therefore "grandfathered." Any debt incurred before December 15, 2017, but refinanced later, continues to be covered by pre-enactment law to the extent the amount of the debt does not exceed the amount refinanced.

For tax years after December 31, 2025, the $1 million limitation applies, regardless of when the indebtedness was incurred.

Suspension of miscellaneous itemized deductions subject to the 2% floor

Suspension of exclusion for qualified moving expense reimbursements

Suspension of deduction for moving expenses

The new law suspends the deduction for moving expenses for years 2018 through 2025. However, the targeted rules providing income exclusions to members of the U.S. Armed Forces (or their spouse or dependents) are retained.

The effective date is for tax years beginning after December 31, 2017.

Modification to individual Alternative Minimum Tax (AMT)

The new law temporarily increases the AMT exemption amounts and the phase-out thresholds for individuals.

For married taxpayers filing a joint return (or for a surviving spouse): The AMT exemption amount for 2018 increases from $86,200 under pre-enactment law to $109,400. The phase-out threshold increases from $164,100 to $1,000,000.

For married taxpayers filing a separate return: The AMT exemption amount increases from $43,100 (under pre-enactment law for 2018) to $54,700. The phase-out threshold increases from $82,050 to $500,000.

For all other individual taxpayers: The exemption amount for 2018 under pre-enactment law is $55,400. The new law raises this amount to $70,300. The phase-out threshold increases from $123,100 to $500,000.

The increased exemption amounts and phase-out thresholds are scheduled to sunset after December 31, 2025.

Business – In general

Reductions in corporate tax rate and dividends received deduction

The new law eliminates the progressive corporate tax rate structure, and replaces it with a flat tax rate of 21%.

The new rate is effective on January 1, 2018. A blended rate applies to fiscal year taxpayers. In addition, the new law lowers the 80% dividends received deduction (for dividends from 20% through less than 80% owned corporations) to 65% and the 70% dividends received deduction (for dividends from less than 20% owned corporations) to 50%, effective for tax years beginning after 2017.

Corporate AMT

The new law repeals the corporate AMT effective for tax years beginning after December 31, 2017. Any AMT credit carryovers to tax years after that date generally may be utilized to the extent of the taxpayer's regular tax liability (as reduced by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers are refundable (a proration rule with respect to short tax years). Any remaining AMT credits will be fully refundable in 2021.

Modified net operating loss (NOL) deduction

The new law limits the NOL deduction for a given year to 80% of taxable income, effective with respect to losses arising in tax years beginning after December 31, 2017.

The new law also repeals the current carryback provisions for NOLs; the statutory language indicates that this provision applies to NOLs arising in tax years ending after December 31, 2017, although it permits a new two-year carryback for certain farming losses and retains present law for NOLs of property and casualty insurance companies.

The statutory language of the new law provides for the indefinite carryforward of NOLs arising in tax years ending after December 31, 2017, as opposed to the current 20-year carryforward.

Revisions to treatment of capital contributions

The new law modifies section 118, which provides an exclusion from gross income for contributions to the capital of a corporation. Specifically, the new law excludes from section 118 any contribution in aid of construction or any other contribution as a customer or potential customer, as well as any contribution by any government entity or civic group (other than a contribution made by a shareholder as such). This provision applies to contributions made after the date of enactment, unless the contribution is made by a government entity pursuant to a master development plan that is approved prior to the effective date by a government entity.

Cost recovery

Modification of rules for expensing depreciable business assets

Under the new law, the section 179 expensing election is modified to increase the maximum amount that may be deducted to $1 million (up from $500,000 under present law) (the "dollar limit"). The dollar limit is reduced dollar-for-dollar to the extent the total cost of section 179 property placed in service during the tax year exceeds $2.5 million (up from $2 million under present law) (the "phase-out amount"). These limits will be adjusted annually for inflation. The changes are effective for property placed in service in tax years beginning after 2017.

Under pre-enactment law, the section 179 deduction for a sports utility vehicle was $25,000. For tax years beginning after 2017, this limitation is adjusted annually for inflation.

In addition, the new law expands the availability of the expensing election to depreciable tangible personal property used in connection with furnishing lodging – e.g., beds and other furniture for use in hotels and apartment buildings. The election also may include, at the taxpayer's election, roofs, HVAC property, fire protection and alarm systems, and security systems, so long as these improvements are made to nonresidential real property and placed in service after the date the realty was first placed in service. These expansions to the definition of property eligible for the section 179 expensing election are be effective for property placed in service in tax years beginning after 2017.

Temporary 100% expensing for certain business assets

The new law extends and modifies the additional first-year depreciation deduction ("bonus depreciation").

Under the new law, generally, the bonus depreciation percentage is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023. It also provides a phase down of the bonus depreciation percentage, allowing an 80% deduction for property placed in service in 2023, a 60% deduction for property placed in service in 2024, a 40% deduction for property placed in service in 2025, and a 20% deduction for property placed in service in 2026. These same percentages apply to specified plants planted or grafted after September 27, 2017, and before 2027.

Longer production period property and certain aircraft get an additional year to be placed in service at each rate.

The new law changes the definition of qualified property (i.e., property eligible for bonus depreciation) by including used property acquired by purchase so long as the acquiring taxpayer had not previously used the acquired property and so long as the property is not acquired from a related party. In addition, the new law excludes any property used in providing certain utility services if the rates for furnishing those services are subject to ratemaking by a government entity or instrumentality or by a public utility commission, and any property used in a trade or business that has "floor plan financing indebtedness."

Requirement to capitalize section 174 research and experimental expenditures

The new law provides that specified research or experimental ("R&E") expenditures under section 174 paid or incurred in tax years beginning after December 31, 2021 should be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures which are attributable to research that is conducted outside of the United States (for this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States) would be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the tax year in which such expenditures are paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

Business-related deductions, exclusions, etc.

Limitation on the deduction of net business interest expense

The new law amends section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income plus floor plan financing interest.

The new limitation does not apply to certain small businesses, that is, any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) that meets the gross receipts test of section 448(c) (which is modified to $25 million under section 13102 of the new law) for any tax year. This exception to the limitation applies to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed $25 million.

The new limitation also does not apply to the trade or business of performing services as an employee or to certain regulated public utilities and electric cooperatives. In addition, certain taxpayers may elect for the interest expense limitation not to apply, such as certain real estate businesses and certain farming businesses; businesses making this election are required to use the alternative depreciation system (ADS) to depreciate certain property. For an electing real estate business, ADS would be used to depreciate nonresidential real property, residential rental property, and qualified improvement property. For an electing farming business, ADS would be used to depreciate any property with a recovery period of 10 years or more.

Adjusted taxable income generally is a business's taxable income computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the amount of any net operating loss deduction; (4) the 20% deduction for certain passthrough income, and (5) in the case of tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. A business's adjusted taxable income may not be less than zero for purposes of the limitation.

Subject to the special rules for partnerships, any business interest disallowed would be carried forward indefinitely. Carryover amounts are taken into account in the case of certain corporate acquisitions described in section 381 and are subject to limitation under section 382.

The provision is effective for tax years beginning after 2017.

Repeal deduction for income attributable to domestic production activities

Under the new law, the deduction for domestic production activities provided under section 199 is repealed for tax years beginning after December 31, 2017.

Limits on like-kind exchange rules

The new law limits the like-kind exchange rules under Code section 1031 to exchanges of real property. The new section 1031 rules apply to exchanges completed after December 31, 2017.

Limitation of deduction by employers of expenses for entertainment and certain fringe benefits

The new law repeals deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business. The new law provides that no deduction is allowed for (1) an activity considered entertainment, amusement, or recreation, (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes, or (3) a facility or portion of a facility used in connection with any of the above.

The new law generally retains the 50% deduction for food and beverage expenses associated with a trade or business, effective for amounts paid or incurred after December 31, 2017. The new law also applies the 50% limitation to certain meals provided by an employer that are currently 100% deductible. The expanded 50% limit applies to food and beverages provided to employees as de minimis fringe benefits, to meals provided at an eating facility that meets the requirements for an on-premises dining facility, and to meals provided on-premises to employees under section 119 for the convenience of the employer. The 50% deduction limit applies for years after 2017 and before 2026. The on- premises meals and section 119 meals expenses would be nondeductible after 2025.

Modification of limitation on excessive employee remuneration

The new law repeals the exceptions to the section 162(m) $1 million deduction limitation for commissions and performance-based compensation. The new law clarifies that the definition of "covered employee" includes the principal executive officer, principal financial officer, and the three other highest paid officers. The new law provides that once an employee is treated as a covered employee, the individual remains a covered employee for all future years, including with respect to payments made after the death of a covered employee. The explanatory statement provides that an individual who is a covered employee in a tax year after December 31, 2016 remains a covered employee for future years.

Further, the new laws expand the definition of a "publicly held corporation" to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. Under the explanatory statement, the definition of public company may include some corporations that are not publicly traded, such as large private C or S corporations.

The effective date of the provision is for tax years beginning after 2017.

Tax gain on the sale of a partnership interest on look-through basis

The new law amends section 864(c) to treat gain or loss on a sale of a partnership interest as effectively connected with a U.S. trade or business to the extent that a foreign corporation or foreign individual that owns the partnership interest (whether directly or indirectly through other partnerships) would have had effectively connected gain or loss had the partnership sold its underlying assets.

The new law also requires that the transferee of a partnership interest withhold 10% of the amount realized on a sale or exchange of the interest unless the transferor certifies that it is not a foreign person and provides a U.S. taxpayer identification number.

The substantive tax provision applies to transfers occurring on or after November 27, 2017; however, the withholding tax obligation only applies to transfers occurring after December 31, 2017.

International

Establishment of participation exemption system for taxation of foreign income

Add U.S. participation exemption

The new law adds a new Code section 245A that would allow a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a specified 10% foreign corporation a 100% dividends received deduction ("DRD") for the foreign-source portion of dividends received from the foreign corporation (a "100% DRD"). The 100% DRD is available only to domestic C corporations that are neither real estate investment trusts nor regulated investment companies.

Mandatory repatriation

The new law includes a transition rule to effect the participation exemption regime. This transition rule provides that the subpart F income of a specified foreign corporation (SFC) for its last tax year beginning before January 1, 2018, is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of November 2 or December 31, 2017 (a measuring date). A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder. This mandatory inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer's share of the foreign E&P deficit of each SFC with respect to which it is a U.S. shareholder and the taxpayer's share of its affiliated group's aggregate unused E&P deficit.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's mandatory inclusion at a 15.5% rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an 8% rate otherwise.

Foreign tax credits

The new law allows the use of foreign income taxes associated with the taxable portion of the mandatory inclusion. Foreign tax credits are disallowed to the extent that they are attributable to the portion of the mandatory inclusion excluded from taxable income pursuant to the participation deduction (55.7% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 15.5%; 77.14% of the foreign taxes paid attributable to the non-cash portion of the inclusion taxed at 8%).

Payment

The new law provides that the tax assessed on a U.S. shareholder's mandatory inclusion is payable in the same manner as its other U.S. federal income taxes and that such tax assessed may be paid over an 8-year period. The new law requires that 8% of the tax be paid in each of the first five years, 15% in the 6th year, 20% in the 7th year, and 25% in the 8th year.

Current year inclusion of global intangible low-taxed income by United States shareholders

A provision (section 14201 of the new law) would add new Code section 951A, which would require a U.S. shareholder of a CFC to include in income its "global intangible low- taxed income" ("GILTI") in a manner similar to subpart F income. The statutory language allows a deduction for corporate shareholders equal to 50% of GILTI, which would be reduced to 37.5% starting in 2026. In general, GILTI would be the excess of a shareholder's CFCs' net income over a routine or ordinary return.

These rules are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

Add deduction for foreign-derived intangible income

In conjunction with the new minimum tax regime on excess returns earned by a CFC, the new law provides a 13.125% effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales (including licenses and leases) or services, which would increase to 16.406% starting in 2026. Specifically, for tax years 2018-2025, the new law allows a U.S. corporation a deduction equal to 37.5% of its "foreign-derived intangible income" ("FDII"). Starting in 2026, the deduction percentage would be reduced to 21.875%.

A U.S. corporation's FDII is the amount of its "deemed intangible income" that is attributable to sales of property (including licenses and leases) to foreign persons for use outside the United States or the performance of services for foreign persons or with respect to property outside the United States. A U.S. corporation's deemed intangible income generally is its gross income that is not attributable to a CFC, a foreign branch, or to domestic oil and gas income, reduced by related deductions (including taxes) and an amount equal to 10% of the aggregate adjusted basis of its U.S. depreciable assets.

The net result of the calculation is that a domestic corporation would be subject to the standard 21% tax rate on its fixed 10% return on its U.S. depreciable assets and a 13.125% (increased to 16.406% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

The new law also includes special rules for foreign related-party transactions. A sale of property to a foreign related person does not qualify for FDII benefits unless the property is ultimately sold by a related person, or used by a related person in connection with sales of property or the provision of services to an unrelated foreign person for use outside the United States. The provision of services to a foreign related person does not qualify for FDII benefits if the services are substantially similar to the services provided by the foreign related person to persons located in the United States.

The provision is effective for tax years beginning after December 31, 2017.

Modification of stock attribution rules for determining status as a controlled foreign corporation

A provision (section 14213 of the new law) would eliminate a constructive ownership rule in section 958(b)(4) of the Code that prevents downward attribution of stock owned by a foreign person to a U.S. person. As a result, for example, stock owned by a foreign corporation would be treated as constructively owned by its wholly-owned domestic subsidiary for purposes of determining the U.S. shareholder status of the subsidiary and the CFC status of the foreign corporation.

The provision applies to the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent tax years of a foreign corporation, and for the tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

Inbound provisions

Add base erosion and anti-abuse tax (BEAT)

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least $500 million of annual domestic (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and which have a "base erosion percentage" (discussed below) of 3% or higher for the tax year (or 2% for certain banks and securities dealers, which are also subject to a higher BEAT rate, as discussed below). The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.

The targeted base erosion payments generally are amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, and also include amounts paid in connection with the acquisition of depreciable or amortizable property from the foreign related party. The new law also specifically includes cross-border reinsurance payments as base erosion payments.

There are two main exceptions to the provision's scope for otherwise deductible payments. The first is for any "amount" paid or incurred for services that qualify "for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)" and that reflects the total cost of the services without markup. The second is for "qualified derivative payments" for taxpayers that annually recognize ordinary gain or loss (e.g., mark to market) on such instruments, and subject to several exceptions.

The BEAT includes within its scope almost every outbound payment made by corporations subject to the rule, except for payments treated as COGS or otherwise as otherwise as reductions to gross receipts.

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount. This amount equals the excess of 10% of the taxpayer's modified taxable income ("MTI") for the year (5% for 2018), over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit and a certain amount of "applicable section 38 credits" that include the low-income housing credit, renewable energy production credit, and energy credits allowed in that year. Applicable section 38 credits are only included to the extent of 80% of the lesser of the credits or the base erosion tax amount otherwise computed.

MTI is the taxpayer's taxable income, with the base erosion tax benefit amount (including the base erosion percentage of an NOL deduction) added back.

The BEAT computation is modified to raise additional revenue for tax years beginning after December 31, 2025 through the following changes which take effect in such years:

(i) the 10% of MTI input will increase to 12.5% of MTI; and (ii) the tax liability against which 12.5% of MTI is compared is simply regular income tax liability minus all credits, which appears to remove the previously retained benefit of the research credit and qualifying section 38 credits.

Banks and registered securities dealers are subject to a one percentage point higher BEAT rate in every year: 6% for 2018, 11% for 2019-2025, and 13.5% thereafter.

Reporting and penalties

The new law introduces new reporting requirements under the existing Code section 6038A regime (Form 5472) to collect information regarding applicable taxpayers' base erosion payments. The provision would also increase that reporting regime's existing $10,000 penalty to $25,000.

The provision applies to payments paid or accrued in tax years beginning after December 31, 2017.

For more information, download the full report below.

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Tax Reform - KPMG Report on New Tax Law (February 6, 2018)
> (PDF/10.2MB)

https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf

To read KPMG's reports and coverage of subsequent developments, see *TaxNewsFlash-Tax Reform* and *TaxNewsFlash-United States.*

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