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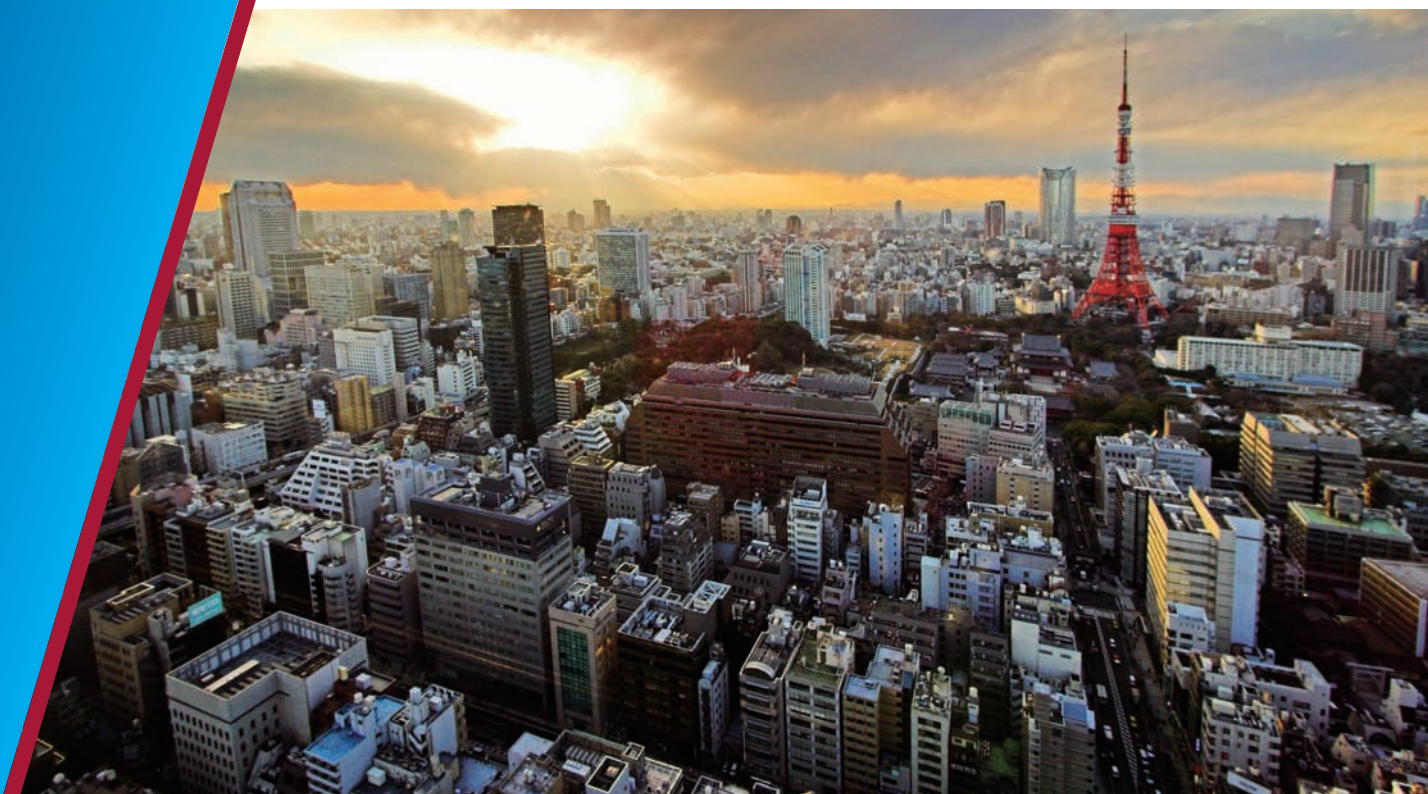
KPMG's U.S. Japanese Practice

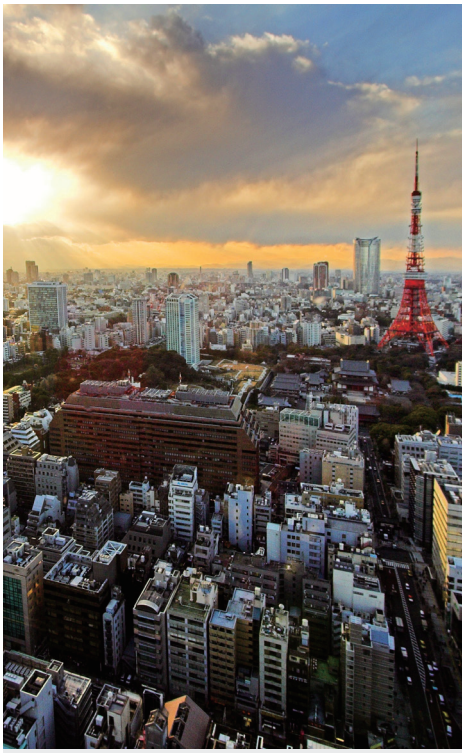
JNET NEWSLETTER

U.S. business update for Japanese companies

Issue 1 – 2015
ENGLISH EDITION

Contents





Setting the Course for Growth: CEO Perspectives

Long term perspectives from the top of the corporate world

After years of navigating through the most significant financial, political and technological disruptions in more than half a century, today's CEOs continue to confront business challenges of unprecedented complexity.

In an economic environment where change moves faster than ever, while growth takes time and focus, business leaders must look beyond the immediate horizon.

KPMG's CEO Study "Setting the Course for Growth: CEO Perspectives" gathers viewpoints from 400 U.S. CEOs, for an in-depth look at the most critical business issues of the next three years, and powerful insights on where U.S. leaders are taking their companies over the long-term.

Key Themes:

- **Confidence**
  More than half of the CEOs surveyed (55%) feel more confident about the economy over the next three years than they did a year ago. Slightly more, 59% and 62% respectively, feel more confident about their industry and their company.

- **Growth Strategy**
  Half of the respondents characterize their overall growth strategy as aggressive, and half as conservative. A vast majority (84%) are either moderately aggressive or moderately conservative, again split roughly in half 72% say that the focus on growth is more important for their companies' well-being than a focus on operational efficiencies. The top growth strategies are geographic expansion and organic growth.

- **Staying Relevant**
  A vast majority of CEOs surveyed (90%) are concerned about competitors taking business away. 72% are concerned about the relevance of products/services three years from now and 59% about new entrants disrupting their business model. In an attempt to stay relevant, the top organizational priorities are promoting and advancing the brand, and more interaction with customers.

- **Transformation**
  76% of CEOs said that their companies are at some stage of transforming or having just transformed their operating models. However, just 16% evaluate their operating models quarterly, and the majority (54%) do it yearly. While spurring innovation is among the top challenges for CEOs, just 17% of companies have developed and implemented a formal, company-wide process for innovation across all units.

- **Regulation**
  Regulatory environment is the top issue that can have the most impact on a company. It is also the second most critical challenge that CEOs expect to face over the next three years (after geographical expansion), according to the survey.

- **Risk Management**
  Risk management is the second-highest concern about the company for the CEOs surveyed (following financial performance). The majority of CEOs either lead the discussions on risk planning or have a strong voice in them (89%). However, risk planning is proactively discussed on a regular basis at just 27% of organizations.

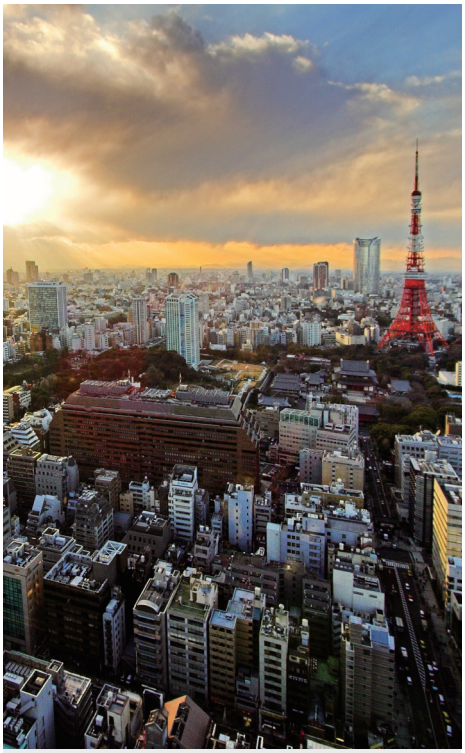
For more information, download the full report below.

Download Now
Setting the Course for Growth >

http://www.kpmginfo.com/ceo-study/documents/ceo-study1.pdf

Questions?

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



2015 Global Audit Committee Survey

Short of a crisis, the issues on the audit committee's radar don't change dramatically from year to year (and they probably shouldn't); but sometimes small shifts tell a big story.

In our 2015 Global Audit Committee Survey, it comes as little surprise to see four key concerns carried over from last: economic and political uncertainty and volatility, regulation and the impact of public policy initiatives, operational risk, and cyber-security. Clearly, a slowing global economy, the flare-up of geopolitical hotspots, and the proliferation of major cyber breaches have intensified the spotlight on these issues. (And in the year ahead, audit committees say they want to devote more time to cyber security and oversight of risk.) But for many audit committees today, these headline risks are also driving a slower-moving—yet critically important—trend potentially impacting the audit committee's effectiveness: agenda overload.

Audit committees, by and large, continue to express confidence in their oversight of the company's financial reporting and audit quality. But the accelerating speed and complexity of business and risk are stretching and straining many audit committee agendas, which often include other major areas of risk—compliance, IT, cyber risk, and others. Of the 1,500 audit committee members responding to our global survey, three out of four said the time required to carry out their responsibilities has increased significantly (24 percent) or moderately (51 percent). Half said the job continues to grow more difficult given the committee's time and expertise.

In a positive development, more boards are reallocating risk oversight responsibilities among their committees and the full board — which bodes well for audit committees. A lighter "risk agenda" can translate into more time for quality discussions and a deeper understanding of the business — two factors that survey respondents said would most improve their audit committee's effectiveness.

Survey respondents also cite ongoing opportunities for improvement in a number of critical areas — from CFO succession planning and getting more insight from external auditors (e.g., on the strengths and weaknesses of the finance organization), to improving the quality of risk information and better leveraging internal audit as a vital resource for the audit committee.

Of course, it's difficult to compare data from 35 countries — often with markedly different business environments, regulatory requirements, and corporate governance practices. But our 2015 survey findings offer insights that audit committees (as well as management teams, auditors, regulators, and others) can use to sharpen the committee's focus, benchmark its responsibilities and practices, and strengthen its oversight going forward.

KPMG's Audit Committee Institutes

Key Findings

- **Uncertainty and volatility, regulation and compliance, and operational risk top the list of challenges facing companies today.** Most audit committees around the world point to economic and political uncertainty and volatility, regulation and compliance, and operational risk and controls as posing the greatest challenges for their companies. Little surprise, given the struggling global economy, ongoing geopolitical turmoil, heightened government regulation, and speed of risk and technology change.
- **Audit committees want to spend more time on risk oversight—particularly cyber security and the pace of technology change.** In the months ahead, audit committees want to devote more—or significantly more—agenda time to overseeing the company's risk management processes and operational risk and controls, as well as cyber security and the pace of technology change (particularly acute concerns in the U.S.)
- **The quality of information about cyber security and technology risk, talent, innovation, and business model disruption is falling short.** Audit committee members rate much of the information they receive as good or generally good, yet many continue to express concerns about the information they receive (at the committee or full board level) related to cyber risk and technology change, talent management, growth and innovation, and possible disruption to the business model. (The CIO ranks lowest in terms of quality interaction and communication with the audit committee.) Exposure to (and readiness for) critical infrastructure failures—financial systems, telecommunications networks, transportation, energy/power—may also require more attention.
- **More boards are reallocating risk oversight duties as the audit committee's workload becomes more difficult.** Three quarters of audit committee members say the time required to carry out their duties has increased moderately (51 percent) or significantly (24 percent); and half said that, given the audit committee's agenda time and expertise, their role is becoming "increasingly difficult." More than one-third of boards have recently reallocated risk oversight duties among the full board and its committees (up from 25 percent last year) or may consider doing so in the near future.
- **CFO succession planning is still a major gap; and many audit committees want to dive deeper into finance issues.** Assessments of CFO performance and interactions with the audit committee are generally viewed as effective; yet more than 40 percent of audit committee members say the committee is "not effective" in CFO succession planning (clearly a pressing issue given the accelerating rate of CFO turnover). Many audit committees would like to hear about various aspects of the finance organization's work—financial risk management, capital allocation, tax, debt—in greater depth.
- **Views on audit reforms are mixed; and while confidence in audit quality continues to be strong, there's still room for auditors to improve.** Across the globe, audit committee views on whether the EU's audit reforms (including mandatory rotation) will improve audit quality vary widely, with the greatest skepticism in the U.S. (only eight percent view such reforms positively). The greatest areas for external auditors to improve their performance: offering insights and benchmarking on industry-specific issues; helping the audit committee stay up to speed; and sharing views on the quality of the financial management team. On internal audit, audit committees are still looking for greater value.
- **A deeper understanding of the business, greater diversity of thinking, more open dialogue, and IT expertise would most improve the audit committee's effectiveness.** Audit committees say they would be more effective in their role by having a better understanding of the company's strategy and risks; more "white space" time on the agenda for open dialogue; greater diversity of thinking, perspectives, and experiences; and technology expertise on the committee. In terms of assessing their effectiveness, "facilitated, open committee discussion" is thought to be more effective than survey questionnaires and third-party interviews of committee members.

For more information, download the full report below.

Download Now
2015 Global Audit Committee Survey >

http://www.kpmg.com/channelislands/en/IssuesAndInsights/ArticlesPublications/Documents/2015-global-audit-committee-survey.pdf

Questions?

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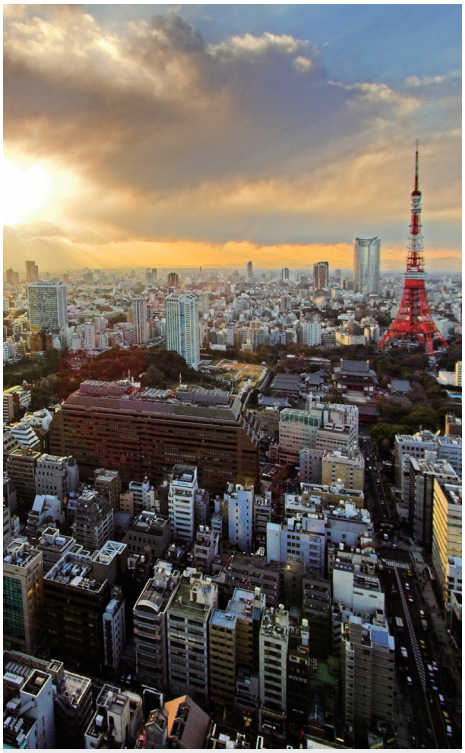

Conflict Minerals and Beyond - Part Four: Lessons for an Integrated Compliance Program

This KPMG International report, "Conflict Minerals and beyond – Part four: Lessons for an integrated compliance program", is the final in a four-part series that looks at Section 1502 of the Dodd-Frank and Wall Street Reform and Consumer Protection Act and its impact on companies around the world.

The report considers the lessons learned thus far and how they can be applied to a holistic compliance program covering a wide range of regulations, not just those relating to conflict minerals. It also examines the way in which companies have complied with the regulations in the first reporting period. It includes case studies of companies that have been working on conflict minerals – offering insights into challenges, lessons learned, and ideas for developing a conflict minerals program.

The annual filing of a conflict minerals report to the SEC is not the end of the matter. Companies can expect to see increased pressures for supply chain transparency and having to meet stricter disclosure requirements in the future. KPMG recommends filers should not regard conflict minerals compliance merely as a box-ticking exercise, but as an opportunity to build a supply chain program in which the links between different regulations are clearer and the management of regulatory risk is made more coherent.

Key lessons:

- Companies should set up systems and processes to meet increasing demands for supply chain transparency.
- A risk-based approach to compliance should help companies to gain deeper insights into their supply chain and to optimize their operations. A little knowledge of the supply chain is a dangerous thing; knowing more can only improve the way to run a business.
- By integrating conflict minerals reporting compliance with other regulations, companies should be able to see how regulatory risks are connected. A holistic approach to compliance will improve efficiency and help companies to manage risk more effectively.
- An integrated review of filings reduces the risk of inaccurate reporting and thus the risk of non-compliance; accurate reporting should help compliance.
- The risk of being found non-compliant with an important regulation affects a company's reputation. A rigorous approach to conflict minerals can enhance a company's reputation.

For more information, download the full report below.

Download Now
Conflict minerals and beyond – Part four: Lessons for an integrated compliance program >

http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/conflict-minerals/Documents/conflict-minerals-beyond-part-four-new.pdf

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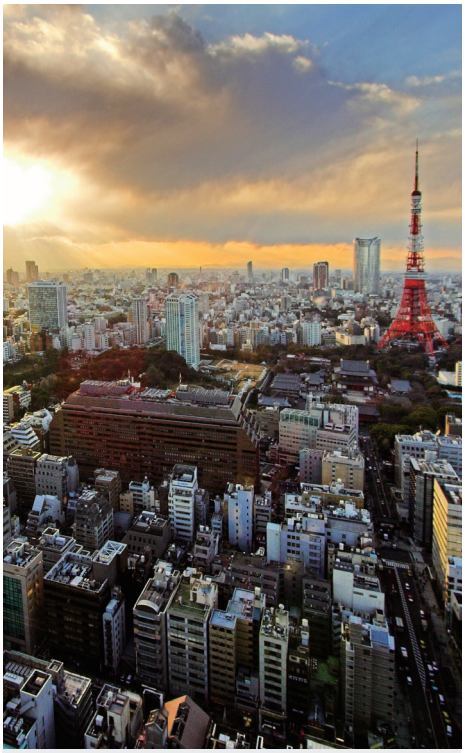

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Auditing & Accounting Update

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

Revenue Transition Resource Group Discusses Five New Issues

The Joint Transition Resource Group for Revenue Recognition (TRG) met for the second time on October 31, 2014, and discussed following five new issues related to the new revenue recognition standard:.

- Evaluating customer options for additional goods and services and nonrefundable upfront fees
- Evaluating contract assets and contract liabilities for presentation purposes
- Determining the nature of a license of intellectual property
- Applying the "distinct in the context of the contract" criterion
- Evaluating contract enforceability and termination clauses to determine the contract period

Go to Defining Issues 14-49 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-49-revenue-trg-discuss-new-issues.pdf

Regulators Finalize Risk-Retention Rule for ABS

On October 22, 2014, federal regulators published a final risk-retention rule (Final Rule) that requires sponsors of securitized financial assets to retain a minimum of five percent of the credit risk unless certain exceptions are met. The Final Rule implements Section 941 of the Dodd-Frank Act, which is intended to encourage sound underwriting practices and to better align the interests of securitizers with investors in both public and private transactions.

Go to Defining Issues 14-50 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-50-risk-retention.pdf

FEI Holds Conference on Current Financial Reporting Issues

In the 33rd annual Financial Executives International conference on current financial reporting issues held on November 17-18, 2014, the conference discussed developments at the FASB, SEC, and PCAOB. Panelists included representatives from standard setters, regulators, preparers, and accounting firms.

Go to Defining Issues 14-51 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/di-14-51-fei-holds-conference-current-fin-report-issues.pdf

FASB Continues Discussion on Disclosure Framework

On December 1, 2014, the FASB began redeliberations and held a forum on financial disclosure to discuss the status of its Disclosure Framework project. A panel discussion included representatives from financial statement users, preparers, legal firms, auditing firms, and representatives from the FASB, SEC, and IASB. During redeliberations of the project, the FASB tentatively decided to revise its description of materiality in FASB Concepts Statement 8, Conceptual Framework for Financial Reporting – Chapter 1, The Objective of General Purpose Financial Reporting; and Chapter 3, Qualitative Characteristics of Useful Financial Information, to align it with a U.S. Supreme Court decision.

Go to Defining Issues 14-52 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-52-disclosure-framework.pdf

FASB Proposes Additional Disclosures for Investment Companies

On December 4, 2014, the FASB issued a proposed Accounting Standards Update that would change the disclosure requirements for investment companies that invest in other investment companies.

Go to Defining Issues 14-53 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2014/defining-issues-14-53-investment-companies.pdf

FASB Issues Private Company Alternative to Account for Identifiable Intangible Assets

In December 2014, the FASB and Private Company Council issued guidance that gives private companies an alternative to include certain identifiable intangible assets in goodwill when applying purchase accounting in business combinations. This election also requires the private company to amortize goodwill under the previously issued goodwill alternative. The guidance is effective prospectively for in-scope transactions occurring in the first annual period beginning after December 15, 2015. Early adoption is allowed.

Go to Defining Issues 15-1 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2015/defining-issues-15-1-private-company.pdf

FASB Eliminates Extraordinary Items Concept

In January 2015, the FASB issued an Accounting Standards Update (ASU) that eliminates the concept of extraordinary items from U.S. GAAP as part of its simplification initiative. The ASU does not affect disclosure guidance for events or transactions that are unusual in nature or infrequent in their occurrence. The ASU aligns U.S. GAAP more closely with IFRS. Entities will continue to evaluate whether items are unusual in nature or infrequent in their occurrence for presentation and disclosure purposes and when estimating the annual effective tax rate for interim reporting purposes.

Go to Defining Issues 15-2 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2015/defining-issues-15-2-extraordinary-items.pdf

FASB Proposes Changes to Accounting for Income Taxes on Intercompany Transfers and Deferred Tax Classification

On January 22, 2015, the FASB issued proposed Accounting Standards Updates that would require entities to recognize the income tax consequences of intercompany asset transfers and classify all deferred tax assets and liabilities as noncurrent in a classified statement of financial position. The proposals, if finalized, would result in convergence with International Financial Reporting Standards on these topics

Go to Defining Issues 15-3 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2015/defining-issues-15-3-accounting-income-taxes.pdf

Revenue Transition Resource Group Discusses Issues

The Joint Transition Resource Group for Revenue Recognition (TRG) met for the third time on January 26, 2015, and discussed several issues related to the new revenue recognition standard. The FASB plans to make a decision about the effective date early in the second quarter of 2015, and will continue to meet with preparers, auditors, and financial statement users to complete their outreach. The Boards will hold a joint meeting in February to discuss potential clarifications on determining the nature of a license of intellectual property and the scope and application of the sales- and usage-based royalties exception and applying the distinct in the context of the contract criterion.

Go to Defining Issues 15-4 >
http://www.kpmg-institutes.com/content/dam/kpmg/financialreportingnetwork/pdf/2015/defining-issues-15-4-revenue-transition-group.pdf

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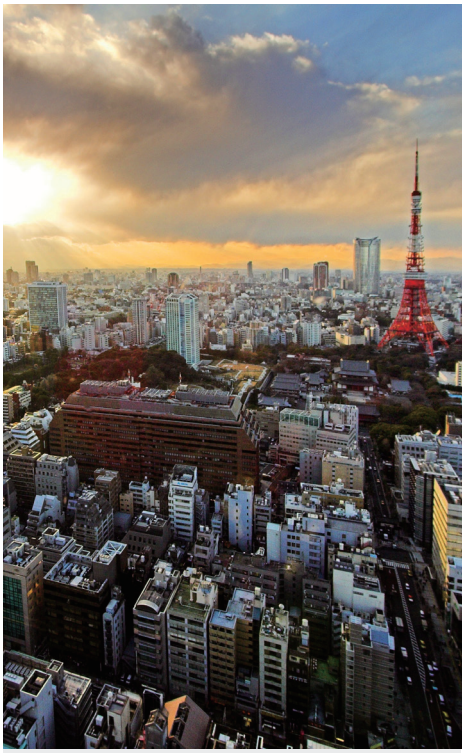

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Tax Update

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.

January 2015

Revenue Scoring Rules Approved by the House

On January 6, the House approved H. Res. 5—a change to its rules that directs the Congressional Budget Office and the Joint Committee on Taxation to incorporate macroeconomic effects (e.g., changes in gross national product, employment, and capital stock) into revenue estimates of "major" tax legislation provided under the Congressional Budget Act of 1974.

In the past, Joint Committee on Taxation ("JCT") official estimates have taken into account behavioral changes associated with tax legislation, but have held GNP fixed.

House Rule XIII (adopted in 2003) also directs the JCT to prepare an analysis of the macroeconomic effects of tax legislation reported by the Ways and Means Committee, but that analysis is not part of the official revenue estimate.

When Rep. Dave Camp, then chair of the House Ways and Means Committee, released his tax reform proposal last year, he requested an alternate, non-official, estimate that considered the proposal's macroeconomic effects on revenues. The JCT analyzed the Camp proposal using different models that employed different assumptions about the deficit, monetary and fiscal policies, sensitivities of individual labor and savings choices and business decisions to changes in tax law, and other matters. Depending on the model and assumptions used, the JCT projected that the reform proposal would increase revenues relative to the conventional revenue estimate by as little as $50 billion to as much as $700 billion, over the 10-year budget period.

The new House resolution—H. Res. 5—goes one step further and requires the JCT to produce a "point" estimate of the revenue effect of major tax legislation that takes into account macroeconomic changes, as opposed to a range of possible results, and that estimate would be the official estimate of revenue.

It is thought that, to the extent the macroeconomic model employed by JCT shows increased growth and, consequently, more revenue raised than under conventional scoring rules, the use of such an estimate could change the dynamic and substance of tax reform by permitting greater revenue-neutral reductions in tax rates or allowing preservation of tax preferences.

The Senate has not yet considered a complementary rule.

Senate Finance Chair Addresses Tax Reform, Inversions

On January 23, Senate Finance Committee Chairman Orrin Hatch (R-UT) delivered a wide-ranging speech on the topics of international taxation, inversions, and tax reform.

In his speech presented at a Brookings Institution conference, Corporate Inversions and Tax Policy, Chairman Hatch reiterated his view that the best way to address the issue of inversions is business tax reform. He said:

- The best solution to [inversions] is, in my view, tax reform. Tax reform, if it's done right, will help grow our economy, create jobs in the U.S. and discourage businesses from leaving our shores and invite businesses to set up and locate here. . . . I believe there is real momentum to get something done on tax reform this year, if we remain committed. And, believe me, I'm committed.

Hatch also discussed how tax reform, in his view, is to address the taxation of multinationals, expressing his preference for a territorial system:

- For my part, I don't believe in a worldwide tax system. I believe we need to go a different direction when it comes to taxing international income and move from our worldwide-leaning international tax system more toward territoriality.
- For the record, I'm no fan of inversions…. I see these inversions as symptomatic of a dysfunctional tax code that is taxing at too high a rate and is attempting to tax worldwide income.
- We cannot be competitive with our current treatment of taxation of foreign-source business income and our current tax rates.

Finally, Hatch addressed his plans for pursuing tax reform this year. He committed to introduce his own tax reform bill, and to mark it up in the Senate Finance Committee this year.

Hatch previously stated, in a Finance Committee release, that he expects the various Senate Finance tax reform working groups to report their findings to the full committee by the end of May.

Proposed Regulations on Research Credit for Internal Use Computer Software Development

On January 16, the Treasury Department and IRS released a notice of proposed rulemaking (REG-153656-03) concerning the application of the research credit for computer software development for internal use purposes.

These regulations have been long-awaited. The IRS issued final regulations (T.D. 9104) on many aspects of the research credit at the end of 2003, but deferred addressing the rules dealing with internal use software.

Under section 41(d)(4)(E), no research credit is allowed for internal use software development except as provided by regulations. The IRS earlier issued several regulatory proposals on the subject, and assured taxpayers that a credit is allowed if the software development meets some additional requirements referred to as the "high threshold of innovation test."

There has been continuing controversy over the definition of internal use software and the precise application of this test. The IRS announced at the beginning of 2004 that work would continue on proposed regulations on this subject.

A hearing at the IRS on the proposed regulations has been scheduled for April 17, 2015. The proposed regulations, once finalized, will be prospective only, applicable in tax years ending on or after the date final regulations are published in the Federal Register. However, the IRS will not challenge return positions consistent with the proposed regulations for tax years ending on or after January 20, 2015.

Senate Bill to Repeal Medical Device Excise Tax

On January 13, the Senate Finance Committee announced that a bipartisan group of 10 Senators, led by Chairman Orrin Hatch (R-UT), introduced a bill that would repeal the medical device excise tax.

A provision of the Patient Protection and Affordable Care Act imposes an excise tax, at a rate of 2.3%, on sales by manufacturers and importers of certain medical devices. The medical device excise tax was effective in January 2013.

December 2014

"Tax Extenders" Enacted

On December 19, Tax Increase Prevention Act of 2014 (the "Act") was signed into law by President Obama. The Act was passed by the House and the Senate on December 3 and December 17, respectively.

The Act retroactively extends most of the provisions that expired at the end of 2013 (or that expire during 2014) — the "tax extenders" — for one year, until the end of 2014. Therefore, Congress will have to address tax extenders in the next session.

In addition to addressing expired provisions, the bill would increase the threshold amount for refunds requiring Joint Committee on Taxation review and approval for C corporations from $2 million to $5 million.

The Act also includes measures allowing certain disabled individuals to set up section 529 savings accounts, as passed by the House as H.R. 647, the Achieving a Better Life Experience (ABLE) Act of 2014.

Congress Extends Internet Tax Freedom Act as Part of Omnibus Spending Bill

On December 15, Congress has passed the 1,603-page omnibus spending bill that includes a provision to extend the Internet Tax Freedom Act until October 1, 2015.

The Internet Tax Freedom Act—which prohibits state and local governments from levying taxes on internet access or discriminatory taxes on electronic commerce — was scheduled to sunset on November 1, 2014. Last month, as part of a joint

resolution to continue funding the government, the provision was temporarily extended until December 11, 2014.

The provision was again extended by Congress. Then, the House and the Senate passed the omnibus spending bill that includes the most recent extension.

IRS Chief Counsel - Taxpayer Derives No DPGR from Computer Software "App" that Customers Download Free of Charge

On December 5, the IRS posted a memorandum that concludes that for purposes of section 199, a taxpayer does not derive any domestic production gross receipts ("DPGR") from the disposition of computer software that allows customers to download an application (App) free of charge when the App only allows customers to access the taxpayer's online fee-based services. AM2014-008 (release date December 5, 2014, and dated November 21, 2014)

The taxpayer (a bank) offers banking services to customers by a variety of means, including online banking which may be accessed when customers use the bank's App. The bank does not charge customers a fee to download or use its App, but customers may incur fees for receiving some banking services that are provided by the App (with the fees being equal to those that customers would incur for banking services received via the website).

The IRS memo concludes that: (1) the bank does not dispose of computer software when customers download the App; (2) the bank does not derive any gross income receipts from its App; and (3) this situation does not satisfy the self-comparable or third -party comparable exceptions under regulations.

The IRS found that even if the download of the taxpayer's App were a disposition, the gross receipts derived from it are entirely from the provision of online fee-based services — and not from a disposition of computer software.

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Senate Finance Republican Staff's Report on Comprehensive Tax Reform

On December 11, the Senate Finance Committee released an over-300-page report — Comprehensive Tax Reform for 2015 and Beyond — prepared by the Finance Committee's Republican staff.

In a press release (transmitting text of the report), Senator Hatch (R-Utah) said that the:

…report is intended to provide background on where we are and where we have been with regard to our tax system as well as some possible direction on where our reform efforts should go in the near future.

The report addresses individual, business, and international issues and sets forth seven guiding principles for tax reform: (1) efficiency and economic growth, (2) fairness, (3) simplicity, (4) revenue neutrality, (5) permanence, (6) competitiveness, and (7) incentives for savings and investment.

The report observes, among many other things, that, because of pass-through entities, it is important that tax reform be approached "in a comprehensive manner, addressing both individual and corporate tax systems."

Tax Court - Motion to Quash IRS Trial Subpoena on Taxpayer's CEO is Granted

On December 10, the U.S. Tax Court granted Amazon.com, Inc.'s motion to quash a trial subpoena served by the IRS on its founder and CEO, Jeff Bezos. The case concerns deficiencies in the taxpayer's income for 2005 and 2006, under section 482, stemming from a cost sharing arrangement executed between the taxpayer and a Luxembourg affiliate (Amazon.com, Inc. v. Commissioner, T.C. Memo. 2014-245 (December 10, 2014)).

Initially, the CEO was not identified by the IRS as one of the fact witnesses that it would seek to depose. The IRS first identified the CEO as a potential witness in

September 2014, and served a trial subpoena for testimony of the CEO.

The taxpayer filed a motion to quash the trial subpoena, asserting that causing the CEO to appear at trial would require a "significant commitment" of his time and would cause a "significant disruption of his management responsibilities" during the taxpayer's peak holiday season.

Following 17 days of trial testimony—including testimony of six members of the taxpayer's senior leadership team—the Tax Court granted the taxpayer's motion to quash the subpoena.

IRS to Open Tax Filing Season as Scheduled, in January 2015

On December 29, the IRS announced that it anticipates opening the 2015 filing season as scheduled, in January 2015.

According to the IRS release (IR-2014-119), with enactment of the extenders legislation earlier in December, the IRS stated that it will begin accepting tax returns electronically on January 20, 2015, with paper tax returns to begin processing at the same time.

November 2014

Post-Election Leadership Changes in Tax Writing Committees

Republican control of the Senate in the next Congress will mean a leadership change in the Senate Finance Committee. Senator Orrin Hatch (R-UT) will become the Finance Committee chairman, replacing Senator Ron Wyden (D-OR). In the House, the chairman of the Ways and Means Committee, Dave Camp (R-MI), announced his retirement earlier this year. Reps. Paul Ryan (R-WI) and Kevin Brady (R-TX) both have stated their interest in becoming the new chairman and are seeking support of House Republicans for leadership of the committee.

California - Out-of-State Limited Partner's 0.2% Interest in Fund did not Trigger Nexus

A Fresno County superior court granted a taxpayer's motion for summary judgment, effectively determining that an Iowa corporation that owned a 0.2% non-managing interest in a fund was not "doing business" in California and was not subject to the $800 minimum tax on corporations. Swart Enterprises Inc. v. FTB, No. 13CECG 02171 (Superior Court, Fresno County, November 14, 2014)

The taxpayer (an Iowa corporation) had no business activities or physical presence or other connection with California other than holding its interest in the fund. The Franchise Tax Board (FTB) asserted that an entity owning an interest in an limited liability owning an interest in an limited liability company (LLC) operating in California is "actively engaging" in transactions "for financial or pecuniary gain or profit."

Although not binding, the superior court in Fresno County found the decision in Appeals of Amman & Schmid Finaz AG, (1996) 96-SBE-008, to be "very persuasive." In that decision, the State Board of Equalization (SBE) noted that limited partners were inactive participants in partnerships and, therefore, were not "actively engaging" in profit-seeking transactions. Further, as limited partners, the partners had no interest in specific limited partnership property; had no right to participate in partnership management; had no authority to bind the partnership; and were not liable for the obligations of the partnerships.

Similarly, in the present case, the court found that the taxpayer had no interest in specific property of the fund; was not personally liable for the fund's obligations; had no right to play a role in the fund's management; and could not act as an agent for the fund or bind it in any way. The Fresno superior court also noted that the taxpayer, as investor in the fund, had no power to exercise control the LLC. Because the taxpayer was not a founding member of the fund, the court determined that it could not be said that the taxpayer once had such control but relinquished it. And even if it had, the taxpayer had such a small ownership interest that it could not have influenced management decisions.

New Jersey: Tax Court Interprets Related Party Expense Disallowance Rule

The New Jersey Tax Court addressed the application of certain exceptions to New Jersey's related-party expense disallowance rules (Morgan Stanley & Co., Inc. v. Director, New Jersey Division of Taxation). Recall, under New Jersey law interest paid to a related party is generally required to be added back in determining New Jersey Corporation Business Tax. There are, however, certain exceptions to the general add back requirement. The taxpayer at issue originally filed returns adding back interest payments made to certain related parties. Later, the taxpayer filed an amended return claiming that it was not required to add back the interest payments at issue and requesting a refund of tax previously paid. The Division of Taxation recalculated the taxpayer's interest expense addback and assessed additional tax. The matter eventually came before the tax court.

In addressing whether the taxpayer was required to add back its interest expense, the tax court addressed two of the statutory exceptions. First, the subject to tax exception permits related-party interest expenses to be deducted to the extent the taxpayer establishes by clear and convincing evidence it meets certain requirements

listed in the statute, including that the related member receiving the interest income is taxed by a state on net income at a rate that is "equal to or greater than a rate three percentage points less than the rate of tax applied to taxable interest" by New Jersey. The other exception at issue in this case was the "unreasonable" exception. This exception simply requires that the taxpayer establish by clear and convincing evidence that the disallowance of the deduction is unreasonable.

The tax court first addressed the taxpayer's argument that certain of the interest payments qualified for the subject to tax exception. Certain recipients of the interest were subject to tax in New York and were included on a New York combined report for the tax year at issue. However, the combined group ultimately paid minimum franchise tax, rather than tax on entire net income. The tax court held that it was clear that the measure of tax imposed on the combined group — a minimum tax — did not include the interest paid by the taxpayer. As such, the court concluded that the taxpayer did not qualify for the subject to tax exception.

The court next addressed whether the taxpayer qualified for the unreasonable exception for the interest paid to affiliates included in the New York return, as well as other affiliates not included in the New York return. Looking to the legislative history behind the enactment of the expense disallowance statute, as well as the statutory language, the court concluded that, contrary to the taxpayer's position, something more than a valid non-tax business purpose and economic substance must be demonstrated in proving the " unreasonableness" of the interest addback. According to the court, indicators that the unreasonable exception might apply would include, but is not limited to, unfair duplicative taxation, a technical failure to qualify the transactions under the statutory exceptions, an inability or impediment to meet the requirements due to legal or financial constraints, an unconstitutional result, or a demonstration that the transaction for all intents and purposes is an unrelated loan transaction.

Texas : Licensed Electronically Downloaded Software and Digital Images Created Physical Presence Nexus for Sales Tax Purposes

A Texas Administrative Law Judge (ALJ) concluded that a taxpayer had sales tax nexus with Texas by virtue of licensing software and digital images to Texas customers. The Utah-based taxpayer licensed digital content and computer software to customers throughout the U.S. All of the licensing agreements provided that the taxpayer retained all property rights to its products. After an audit, the Texas Business Activity Research Team concluded that the taxpayer should have been collecting sales tax on its licenses of software and content to Texas customers. The taxpayer contested the subsequent assessments, and the matter eventually went to the ALJ.

The ALJ noted the licensing agreements between the taxpayer and its customers specifically stated that the taxpayer retained all property rights in its products. In Texas, software (regardless of delivery method) is considered tangible personal property. In the ALJ's view, retaining property rights in the tangible personal property licensed to Texas customers created physical presence in the state.

Questions?

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

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