KPMG

# JP Executive Insight

**U.S. business update for Japanese companies**

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**KPMG's U.S. Japanese Practice**

# Contents



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# JP Executive Insight

**U.S. business update for Japanese companies**

## Post–BEPS Tax Controversy

### Preparing for new rules, new risks

### Introduction

During the final quarter of 2017, multinational enterprises (MNEs) watched as U.S. tax reform legislation went from longshot to enacted legislation in the course of a few months. MNEs are rightly focused on the sweeping changes wrought by the new law. However, savvy tax directors should also be preparing for the coming wave of tax controversy spawned by the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) project—from which global tax law changes have continued apace.

Many countries have adopted, or are in the process of adopting, changes to their international tax systems in response to the OECD's BEPS project, which KPMG LLP (KPMG) expects will drive significant tax controversy for MNEs. In June 2017, approximately 70 nations signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), an agreement that allows countries to quickly adopt key treaty-related measures of the OECD/G20's BEPS tax avoidance guidance without the need for lengthy renegotiations of the thousands of bilateral double tax treaties in existence today between members of the OECD/G20. The most significant and widely adopted treaty-related measures include the introduction of a principal purpose test (PPT) to avoid treaty abuse under Action 6 of the OECD BEPS project and revised permanent establishment (PE) standards under Action 7 of the OECD BEPS project.[1] It is expected that the MLI will enter into force January 1, 2019, and we anticipate the resulting treaty changes will be catalysts for significant increases in global tax controversy.

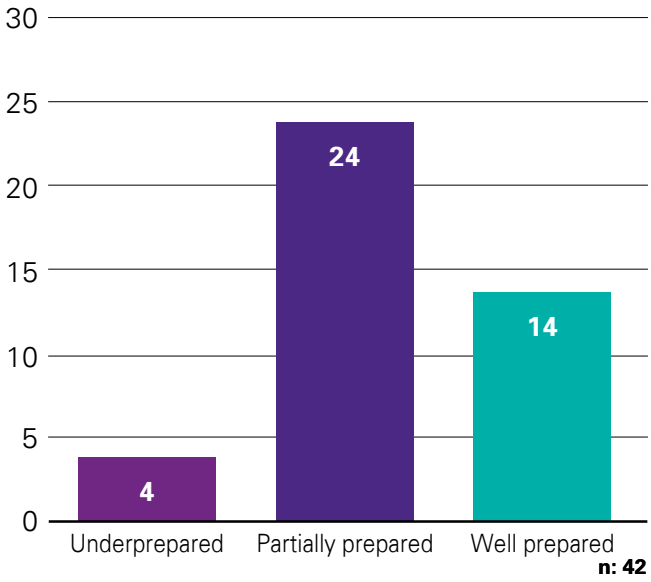
In addition to the MLI, the OECD's recommended changes to rules on transfer pricing and allocation of profit under Actions 8–10,[2] along with the advent of country-by-country (CbyC) reporting under Action 13, introduce new rules and require new data reporting that will also serve as catalysts for controversy. CbyC reporting provides tax administrators with a wealth of data to scrutinize in order to more easily and effectively identify audit targets.[3] MNEs will see their own data being used to pinpoint risk areas, and many MNEs may see a substantial increase in the number of tax audits as a result.

As jurisdictions steadily progress towards implementation of these new BEPS-related measures, a recent KPMG study[4] found that most MNEs are not fully prepared for these changes (see Figure 1).

Further, the scope and breadth of disruption in the global tax landscape will be significant as multiple regulatory changes compete for attention. This has placed incredible pressure upon MNEs' tax departments.

Many MNEs have considered CbyC reporting to be the most applicable change stemming from the BEPS project (see Figure 2), and while we agree CbyC reporting is a fundamental shift in global tax reporting, it is merely one of many new tools in the hands of tax authorities which create an evolving set of tax controversy risks for MNEs. As described above, we also believe changes under Actions 6 (PPT test), 7 (revised PE standards), and 8–10 (updated transfer pricing rules) of the OECD BEPS project will spur increased global tax controversy for MNEs. Below we explore how those changes will be catalysts for increased global tax controversy and what MNEs can do to prepare.

**Figure 1** : When asked "How would you rate your organisation's preparedness for an increase in BEPS-related audit inquiries?," survey participants responded as follows:




**Source:** BEPS Controversy Readiness, November 2017, KPMG LLP

[1] See below for further discussion. [2] *Id.*

[3] The OECD has published two handbooks that outline a broad array of potential risk indicators in CbyC reports, including disparities between profits and functions, low-risk activities, separate intangible property structures and reporting discrepancies, Country-by-Country Reporting: Handbook on Effective Implementation and Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment, organisation for Economic Co-operation and Development.

[4] See BEPS Controversy Readiness, November 2017, KPMG LLP

## BEPS Action 6: The introduction of the PPT

To address perceived treaty abuse, the final report on BEPS Action 6 [5] recommends that a "principal purpose test" be added to tax treaties. The proposed article would generally provide that a treaty benefit shall not be granted if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of the arrangement or transaction that directly or indirectly resulted in that benefit, unless it is established that granting the benefits would be in accordance with the object and purpose of the provisions of the treaty. The article is intended to address issues such as treaty shopping, splitting up of contracts, hiring -out of labor cases, and other situations of perceived treaty abuse.

The MLI includes this PPT by default, although signatories may elect to opt out of the MLI's PPT with respect to treaties that already contain a similar test, or may elect to opt out generally if they elect instead to satisfy the minimum standard set by Action 6 by adopting detailed limitation of benefit and domestic anticonduit rules. To date, all signatories have opted for the PPT.

Because the PPT casts a wide net by asking whether obtaining a treaty benefit was "one of the principal purposes," rather than "the principal purpose," tax authorities have considerable discretion to deny treaty benefits where a purpose of the arrangement or transaction was to obtain the benefit. Taxpayers can, however, find some solace in the second half of the PPT, which provides that taxpayers may still obtain the benefit if the granting of that benefit is in accordance with the object and purpose of the treaty. Although the object and purpose of tax treaties is typically to provide for administrative cooperation and the prevention of double taxation, it may be difficult for taxpayers to argue that a benefit is in accordance with any specific treaty provision.

The PPT's broad authority essentially provides MLI signatories with the power to attack any arrangement or transaction on the grounds of the PPT, regardless of whether that jurisdiction has adopted any particular provision of the MLI. For example, a country may choose not to sign on to the revised PE standards under Action 7 discussed immediately below, yet tax administrators in that country may still attack an MNE's arrangement on the grounds that the arrangement was designed to avoid PE status and for the MNE to avail itself of the associated treaty benefits.

## BEPS Action 7: The revised PE standards

The revised PE standards recommended under Action 7 [6] of the OECD BEPS project are aimed at addressing what the OECD considers to be strategies used to artificially avoid having a taxable presence in a treaty jurisdiction and are included in Articles 12–14 of the MLI.

Article 12 of the MLI expands the dependent agent permanent establishment (DAPE) standard to include arrangements in which a dependent agent habitually and routinely plays a principal role in the conclusion of contracts in the name of a related enterprise without material modification by the related enterprise. This revised DAPE standard is designed to attack principal-company and remote-seller structures in which the principal company does not have sufficient substance to justify local country nontaxation. Similar to existing tax treaty limitation on benefits clauses and triangular provisions, Article 12 of the MLI seeks to empower treaty partners to prevent form trumping substance in the application of treaty benefits.

Article 13 of the MLI provides signatories an option for modifying the application of the specific activity exemptions in the current OECD model treaty. This modification limits the availability of exemptions to circumstances where the activity is "preparatory or auxiliary" in nature. In addition, this article includes an antifragmenta provision. This provision serves to deny the specific activity exemptions when an enterprise or a closely related enterprise carries on business activities in the same State and either: i) those business activities constitute a PE for a related enterprise in the State or ii) the overall combined activity resulting in the State is not of a preparatory or auxiliary character.

Finally, Article 14 of the MLI addresses the splitting up of contracts and requires generally that, for purposes of determining whether the period of time after which specific activities shall constitute a PE has been exceeded, time spent (in excess of 30 days in the aggregate) by the enterprise at a building site or construction or installation project and connected activities at that same site by closely related enterprises (during periods that exceed 30 days) must be aggregated.

By expanding the DAPE standard, narrowing the scope of the specific activity exemptions and providing that activities of related entities within a MNE's group will be aggregated, Articles 12–14 of the MLI will require MNEs to reassess their global structures to ensure that this does not result in unexpected PEs. This is particularly true where local sales and marketing activities have historically been carried out by a different local country entity than is the seller and/or importer of record within a specific jurisdiction (as is common in principal company and similar structures).

[5] See OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris; see OECD (2016), *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[6] OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris; see OECD (2016), *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

## BEPS Actions 8–10: Changes to rules on transfer pricing and allocation of profit

As part of its stated goal of ensuring that transfer pricing outcomes better align with value creation, the OECD provided revised transfer pricing guidance on the allocation of profits under Actions 8–10.[7] Specifically, the guidance provides new frameworks for analyzing allocations of profits in the context of risk and intangibles.

With respect to risk and the arm's-length principle, the key concept from the final report on Actions 8–10 is that an entity must have both control over risk and the capacity to assume risk in order to receive the reward or profits associated with the risk allocated to such entity. The guidance defines control over risk as i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, and ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function. If an entity does not have control and financial capacity with respect to a risk, profits associated with that risk must be reallocated to the entity that does have control and financial capacity.

With respect to determining control over risk in relation to intangibles, the final report clarifies that members of a MNE group are to be compensated based on the value they create through functions performed, assets used and risks assumed in the development, enhancement, maintenance, protection, and exploitation of those intangibles (DEMPE functions).

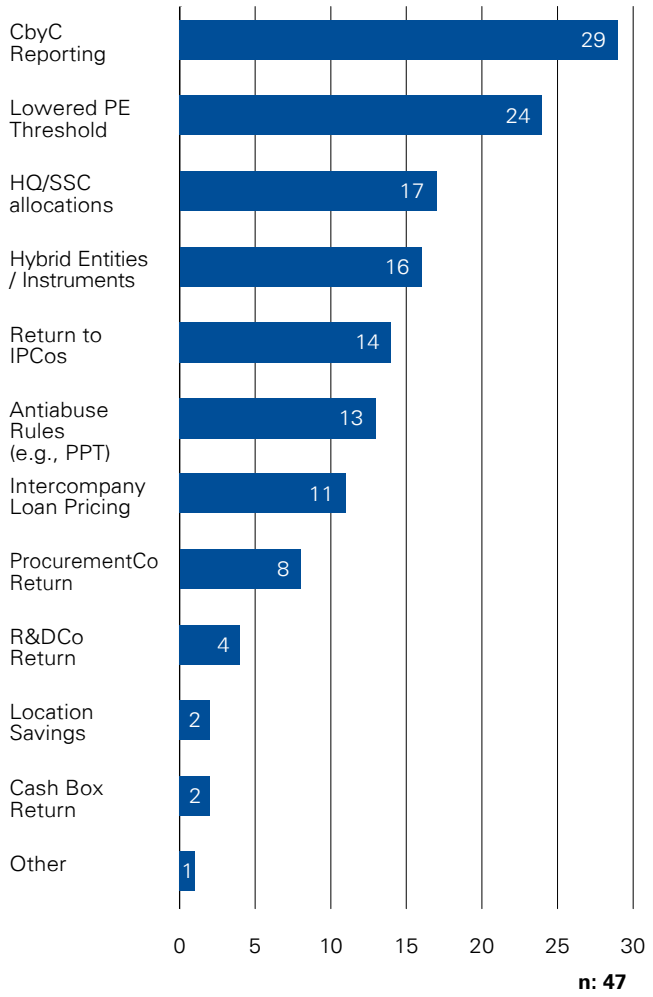
Actions 8–10 emphasize that legal ownership alone of an intangible does not determine entitlement to returns from the exploitation of that intangible; where an enterprise that is not the legal owner of an intangible performs DEMPE functions in relation to the intangible, it can expect arm's-length remuneration. The nature of this remuneration will take into account which enterprises assume and control the risks associated with the DEMPE functions, in accordance with the general guidance on control over risk discussed above.

Actions 8–10 are designed to reinforce the spirit of the arm's-length standard by clarifying the extent to which economic and operational substance must align with contractual allocations of risk within a multinational group in order to justify a particular profit allocation. By nature, such an analysis is highly qualitative and will require MNEs to document how particular functions and activities drive profit within their organisation.

MNEs will face increasing risk if they rely solely on contractual assumptions of risk to determine the appropriate allocation of profits. If MNEs do not examine their businesses to determine whether the form of their contractual assignments of risk aligns with the substance of what is in fact occurring, they risk a tax authority examining and reallocating profits associated with certain risks. This may result in double taxation of these profits.

Likewise, legal ownership alone of an intangible may not entitle a party to returns from the exploitation of that intangible. Instead, the OECD rules consider which entities perform DEMPE functions, have control over the relevant risks, and have financial capacity for those risks to determine entitlement to returns from the exploitation of that intangible. In this new framework, an MNE relying on legal ownership of intangibles to determine the appropriate allocation of profits associated with exploitation of an intangible may be surprised by tax authority examinations and re-allocations, resulting again in possible double taxation.

**Figure 2** : When asked "Over the past three years the OECD's project on BEPS has placed an unprecedented focus on a number of areas of perceived tax abuse. Of the following focus areas, which THREE are the most applicable to your organisation?", survey participants responded as follows:




**Source:** BEPS Controversey Readiness, November 2017, KPMG LLP

[7] See OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10 – 2015 Final Reports,* OECD Publishing, Paris.

## BEPS Action 13: CbyC reporting

Action 13 of the OECD BEPS project aims to enhance transparency for tax administration by introducing a CbyC framework and template reporting mechanism for MNEs to share information with tax authorities in each of the countries in which they have a tax presence.[8] This framework provides for a multitiered standardized approach to transfer pricing documentation.

The first of these tiers is a "master file," which would be made available to all relevant tax administrations that adopt the master file requirement. The OECD master file standard would require MNEs to provide high-level information regarding their global business operations and transfer pricing policies.

The second tier is a "local file" specific to each country, containing detailed transactional transfer pricing documentation and identifying material related-party transactions, the amounts involved in those transactions, and the company's transfer pricing analysis.

The third tier is the actual "Country-by-Country Report," which provides a template that large MNEs (combined revenue of euros 750 million or more) are to complete and file annually for each tax jurisdiction in which they do business. MNEs are to provide information on revenue, profit before income tax, and income tax paid and accrued in their CbyC Report. They also report their number of employees, stated capital, retained earnings, and tangible assets in each tax jurisdiction. Lastly, MNEs identify each entity within the group doing business in a particular tax jurisdiction and provide an indication of the business activities in which each entity engages.

As of February 2018, 81 countries had adopted or expressed their intent to adopt the OECD CbyC report template, while 54 countries had adopted or expressed their intent to adopt the OECD master file and/or local file documentation standard.

The new reporting under Action 13 (master file, local file, and CbyC Report) will make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of shifting substantial amounts of income into tax-advantaged environments and, in the event of an audit, will provide information to help target audit inquiries. The CbyC reporting requirements do not, however, provide sufficient detail to enable tax authorities to distinguish with certainty the aggressive arrangements from those properly structured. As a result, it will become increasingly important for MNEs to have properly documented their global value chains and the economic and operational rationale for their allocation of profit among MNE group entities. Further, the CbyC regime makes it imperative that companies speak with a single voice across jurisdictions and articulate consistent transfer pricing positions. Moreover, the rules themselves pose significant procedural hurdles as governments around the globe institute new filing processes.

## BEPS-style unilateral action

Posing perhaps an equally significant challenge to MNEs' global tax footprint are BEPS-style rules that have been, or are contemplated to be, unilaterally implemented by various countries. These rules introduce new substantive and procedural uncertainty that are not addressed by the OECD and although quite similar in scope, purpose, and design, are not a part of the BEPS project.

Early examples include the United Kingdom's Diverted Profits Tax (DPT), which imposes a punitive tax on profits deemed to be moved out of the United Kingdom's as a result of either an avoided PE or through making payments that lack economic substance (or to a company that lacks economic substance and is located in a low-tax jurisdiction), and Australia's Multinational Anti-Avoidance Law (MAAL), which applies similar avoided PE rules.[9]

While the OECD has just released its interim report on its ongoing work under BEPS Action 1 (Addressing the Tax Challenges of the Digital Economy), countries such as Italy and India have unilaterally pursued digital economy taxes (with Italy enacting a new tax on digital transactions—a 3 percent levy on gross value of the transaction, and India proposing new virtual PE rules as part of its 2018 budget—effective April 2019 when passed). Similarly, on March 21, 2018, the European Commission made two legislative proposals including a new digital or virtual permanent establishment (the Commission's preferred long-term solution) and a tax on certain "digital" revenues (which the Commission views as an interim solution only).

## How to prepare

MNEs that operate in any of the jurisdictions implementing the OECD's BEPS-related recommendations or that rely on tax treaties to avoid costly double taxation with respect to their cross-border operations may be directly affected by these new rules. In particular, as more countries sign and adopt the MLI, taxpayers will need to quickly assess how treaties affecting them will change, evaluate how and when their operations might be affected, and develop plans to address that impact.

Understanding the impacts of the OECD's BEPS-related recommendations and the MLI, especially the catalysts for controversy described above, empowers businesses to make informed decisions about their tax controversy risk. If MNEs do not think ahead and proactively seek to review and refine their global narratives and/or restructure to mitigate risk, they may be unprepared for the coming controversy.

Instead of waiting for risk to materialize, MNEs should consider these leading practices to prepare for and mitigate risk by playing both "offense" and "defense."

[8] OECD (2015), Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

[9] Australia has also adopted DPT rules which apply an economic substance analysis.

## Offense

### The introduction of the PPT

- Comprehensively review your related-party arrangements and transactions to identify any arrangement which appears to have as one of its principal purposes the obtaining of treaty benefits
- Review treaties affecting your business to determine the objects and purposes of those treaties
- Be prepared to argue that certain treaty benefits resulting from your arrangements are in line with the overall goals of administrative cooperation and double taxation; better yet, consider specific treaty provisions that provide support for the receipt of treaty benefits with respect to your intercompany arrangements

### The revised PE standards

- Review your existing global footprint and intercompany distribution agreements to identify exposures under existing PE rules and the revised PE standards adopted as part of the MLI
- Specifically, analyze your supply chain, with a particular focus on any commissionaire or similar dependent agent arrangements, to determine your risk of a tax authority deeming those arrangements a PE
- Consider whether your independent agents will now be considered "dependent" under the new rules
- Prepare for possible changes to PE status in some jurisdictions by revising your tax planning or restructuring your business

### Changes to the rules on transfer pricing and allocation of profit with respect fo risk and intangibles

- Review your company's entire value chain to identify the key drivers of value creation in your organisation and the control of risk functions associated with those value creating activities
- Evaluate your intercompany agreements to ensure that parties contractually assuming risks in fact have control over those risks and the financial capacity to take on those risks
- Ensure that value drivers are appropriately compensated at each level, mitigating the risk of DEMPE-related adjustments

### CbyC reporting

- Standardize your review processes for information to be shared with tax authorities and consider using a central repository for transfer pricing materials
- Eliminate inconsistencies in messaging; speak with a single voice across jurisdictions
- Review CbyC reporting positions in light of industry peers to identify potential audit risk areas based on outlier data in line with recently released guidance on CbyC reporting and CbyC implementation

## Defense

- Prepare documentation supporting your current business model and tranfer pricing under the new rules
- Standardize compliance and dispute resolution procedures across your organization
- Develope standardized review processes for information to be shared with tax authorities and a central repository for transfer pricing materials
- Establish procedures for your local tax teams to follow in local audits and related controversies
- Ensure that local tax teams have the enterprise knowledge to describe global value chains effectively and consistently among jurisdictions
- Anticipate potential tax authority questions and prepare responses which can be leveraged across the company to improve quality and consistency of messaging
- Develop online and social media governance to be shared with employees across the enterprise, especially those involved in R&D activities, to mitigate the risk of affiliates or employees overstating their capabilities or functions online

**In light of newly enacted U.S. tax reform, many MNEs may already be reviewing their operations and considering tax and business model restructuring opportunities. This is a unique moment allowing for tax planning synergies as MNEs can simultaneously consider the BEPS and U.S. tax reform consequences of their operations and respond to these changes in a single coordinated effort. To the extent you need support in reviewing or even remediating your business structure and tax planning in preparation for BEPS controversy, KPMG professionals stand ready to assist.**

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# JP Executive Insight

**U.S. business update for Japanese companies**

## Ready, Set, Fail?

### Avoiding setbacks in the intelligent automation race

**Most intelligent automation (IA) projects underway or currently in the pipeline will fail.**

### Overview

While enterprises have high expectations of the impact of IA, they are not yet ready to implement it from the top down and at scale. Until companies recognize two critical issues, they will struggle to get an adequate return on investment. First, IA investment decisions need to be C-level strategy imperatives, and second, IA is about business and operating model transformation, not simply technology deployment.

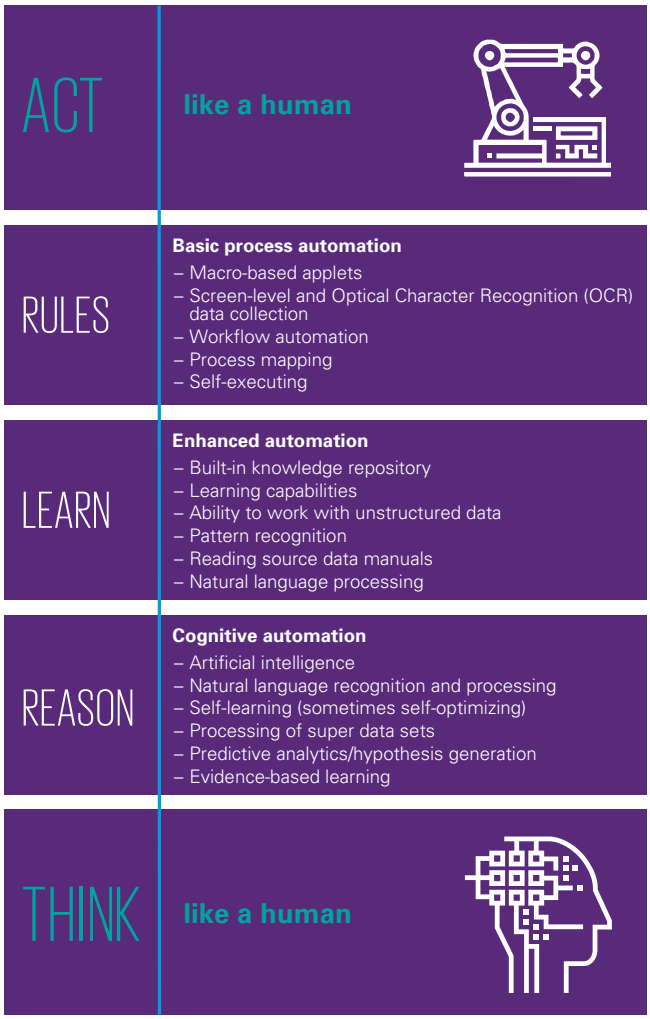
It is not clear whether most companies understand that IA is about changing business processes, and then restructuring the organization around those new processes that are now driven by technologies that did not exist before. This means shifting the business and operating model from one of people supported by technology to one of technology supported by people. It's a digital-first operating model.

KPMG recently undertook a study to understand the reasons for and implications of deploying IA and what it takes to scale. KPMG professionals interviewed executives from numerous industries and geographies worldwide about their experiences with deployment and their perspectives on the future. Most emphasized that IA is poised to digitally transform their companies and industries and profoundly impact their employees' roles.

At the same time, executives highlighted several challenges. In addition to grappling with the extraordinary pace of change, they are faced with understanding and choosing among hundreds of technology options, the need for effective data and analytics, prioritizing automation focus, and defining their future workforce. KPMG research considered three main areas of IA—basic or robotic process automation (RPA), enhanced automation, and cognitive automation.

These results underscore the need to not only act quickly but to also plan deployments strategically with scale in mind. Most companies' executives acknowledged they are still experimenting only with RPA, applied to legacy applications and processes. With such a narrow focus and a bottom-up approach, they have not positioned themselves to transform their business and operating models so they can become and remain competitive with digital-first companies.

### The technology spectrum ranges from task automation to knowledge augmentation




**Source:** KPMG LLP, 2018

**"Many traditional businesses with legacy approaches risk falling behind digital-first companies if they stay with the status quo. It takes a comprehensive transformation of business and operating models to compete in their own market at the level at which a Tesla or Amazon do in theirs."**

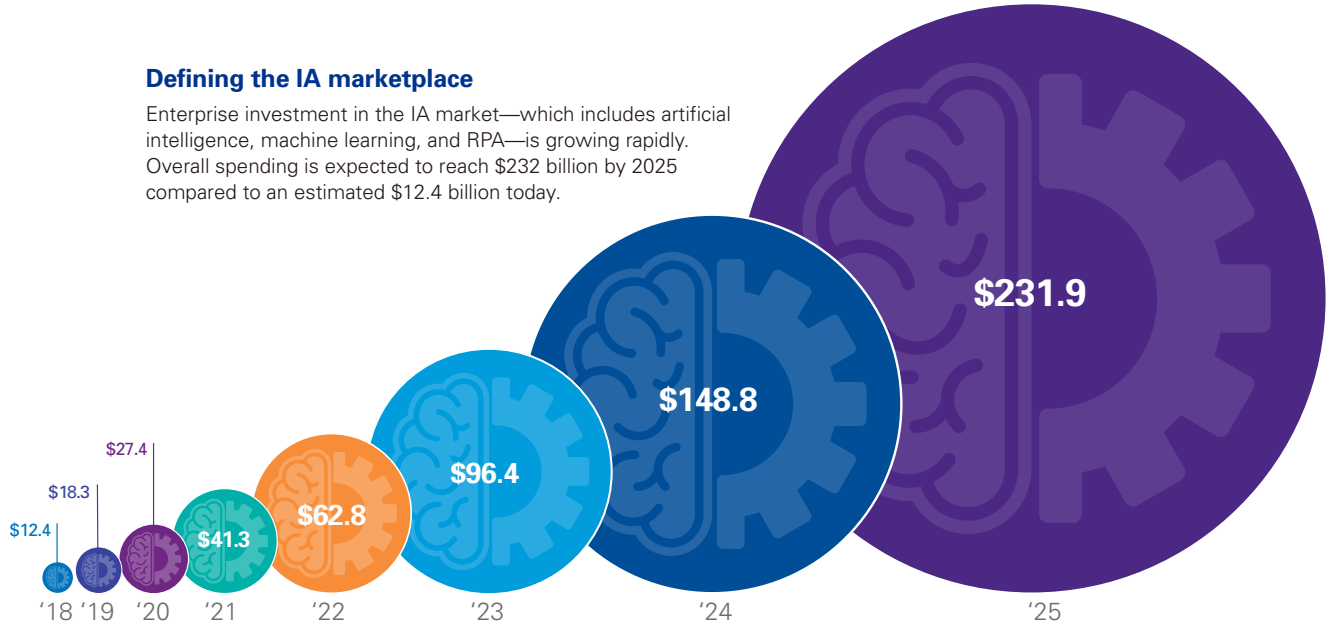
Cliff Justice, KPMG Partner,
Innovation & Enterprise Solutions,
and leader of Cognitive Automation initiatives

As IA use accelerates across industries and organizations worldwide, digital-first companies already have a distinct competitive advantage. Not all companies can emulate Amazon's one-click experience with its complexity and checks-and-balances built into a digital supply chain. Companies can, however, close these gaps if they act quickly, understand the urgency, and define and execute a comprehensive IA strategy—one that not only looks at technology, but also at business and operating model opportunities and constraints.

This report summarizes KPMG's research into how IA is currently impacting business and operating models. It provides recommendations for how companies can plan for and implement an IA strategy that will help enable them to compete with digital-first competitors and thrive in a digitally driven world.

### Defining the IA marketplace

Enterprise investment in the IA market—which includes artificial intelligence, machine learning, and RPA—is growing rapidly. Overall spending is expected to reach $232 billion by 2025 compared to an estimated $12.4 billion today.




**Source:** KPMG LLP, 2018

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## Board Oversight of Corporate Culture

**As we've seen in the headlines, corporate culture is front and center for companies, shareholders, regulators, employees, and customers. Not surprisingly, the focus tends to be on corporate culture as the culprit—with headlines of sexual harassment, price gauging, shady sales practices, and other wrongdoing. As a result, boards themselves are in the headlines— with an expectation that they need to "fix" broken cultures.**

Given the critical role that corporate culture plays in driving a company's performance and reputation—for better or, as evidenced by the #MeToo movement, for worse—it is not surprising that boards today are reassessing their approach to oversight of culture. The key question they are asking: How can we "up our game" and take a more proactive approach to understanding, shaping, and assessing corporate culture?

That was the focus of KPMG's Director Roundtable Series, which gathered more than 500 directors and business leaders in cities across the country during May and June. One director described culture as "a little like faith or gravity. You can't see it or touch it, but it's there and it's a really strong force." Another emphasized that "technology has amplified the ability of customers, employees, and investors, to scrutinize not only what products and profits a company makes, but how it makes them, and if they don't like what they see, the network effect of social media quickly takes over."

The roundtable discussions explored four key areas of board focus as they reassess their oversight of corporate culture:

- Understand what "culture" is and why it is critical today
- Establish clarity on the foundational elements of the company's culture: zero-tolerance policies as well as behaviors that will help the company excel
- Clarify the board's role in overseeing culture— recognizing that visibility is a major hurdle
- Assess where culture belongs on the board and committee agendas.

### Understand what "culture" is and why it is critical today

As Spencer Stuart has noted, culture is not a series of objectives or aspirational values posted on the wall; rather, culture "is the culmination of the shared values, beliefs, and assumptions that shape the behavior of the organization. These 'unwritten rules' guide the thousands of decisions employees throughout the organization make every day." The company's culture is critical because it permeates virtually every aspect of the organization: strategy, execution, risk management, compliance, business processes, employee performance, long-term value creation, etc. It drives corporate behavior in good times and in times of stress.[1]

As one director said, "Done right, culture can be a huge competitive advantage and it can drive shareholder value. We view our culture as one of our greatest advantages." Another director emphasized the importance of expectation and environment:

**"The board and management should describe what's expected and set the right environment so those expectations are possible. You need feedback to make sure that is happening."**

Who is responsible for the organization's culture? It is almost impossible for the board to create culture, though it can influence culture. The CEO is, by far, the most significant driver of culture, along with his or her senior management team. Understanding an organization's culture is difficult because the underlying drivers of culture are usually hidden. But if you can't see it, describe it, or measure it, it's hard to know if your company's culture is helping or hurting the organization.[2]

[1] George Anderson, Michael J. Anderson, and Jeremiah B. Lee, "What Do Boards Need to Know About Culture?" Spencer Stuart, February 2015.
[2] Michael J. Anderson, et al., "Leading With Culture," Spencer Stuart Point of View 2015.

## Establish clarity on the foundational elements of the company's culture: zero-tolerance policies as well as behaviors that will help the company excel

As recommended in the 2017 Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset, boards should strive for a level of discipline with respect to culture oversight that is comparable to leading practices in the oversight of risk. To do that, the board, CEO, and senior management should establish absolute clarity on the foundational elements of the organization's culture in two areas:

1. Behaviors for which there is zero tolerance
2. Values and behaviors that help the company excel and are to be encouraged.

### Zero-tolerance policies

Participants noted the importance of zero-tolerance policies for certain behaviors—such as violence, fraud, racial discrimination, sexual harassment, and, perhaps, drug use—and emphasized the importance of enforcing zero tolerance consistently at all levels of the organization. "If someone behaves in a way that is inconsistent with a behavior for which the company has a zero-tolerance policy and you make an exception for them because they're a top performer, it's essentially granting permission for everyone to behave the same way."

So how does a board and management team develop an effective zero-tolerance policy? The #MeToo movement provides some important lessons for boards as to how to establish absolute clarity regarding its zero-tolerance policy for harassment and abuse. Examples include:

- Send a clear message from board and senior management that they are committed to preventing workforce harassment and abuse at all levels and that the issue is a top priority for the board
- Assess soundness of sexual harassment policies, training, and enforcement
- Assess effectiveness of employee hotline mechanisms, including processing and escalation
- Identify types of complaints that must be brought to the board's attention
- Consider whether compensation incentives— including clawbacks— exist to motivate compliance and the right behaviors
- Monitor red flags
- Clarify duty of officers and directors to share workforce misconduct information with the full board
- Recognize importance of board independence, diversity, and refreshment as essential to good governance.

As one director said, "It's essential for companies and boards to get the zero-tolerance policy right and to make it effective."

### Values and behaviors that help the company excel and are to be encouraged

The NACD Blue Ribbon Commission recommended that boards also work with management to establish clarity around the values and behaviors that help the company excel and are to be encouraged—i.e., the behaviors that are key to execution of the company's strategy. Of course, the types of behaviors the company might encourage will vary based on its strategy. For example, a company that is positioned as a disruptor will encourage different behaviors than one that is heavily regulated (see image below).


**Source:** KPMG Board Leadership Center, 2018

Obviously, the types of behaviors a company encourages will vary depending on where the company is on the spectrum. Roundtable participants emphasized that the key is for the board and management to agree on the desired culture and behaviors and to ensure that there is alignment of the desired culture and behaviors with strategy, values, and incentives, as well as controls to help identify any outliers.

While the CEO sets the company's culture, the board plays an important role in influencing it by making culture a priority, modeling the desired culture, and selecting the CEO, and through its influence on policies related to succession planning and talent development, incentive compensation, hiring, firing, and promotion decisions.[3]

Speakers stressed the importance of considering culture fit up front, during the hiring process, particularly as part of the CEO succession process. "Be deliberate. Do a tremendous amount of due diligence."

"It starts with hiring individuals who match the company's values," said one director. "It doesn't have to cost a lot of money, but it does cost time in the form of up-front investment in the hiring processes."

[3] Financial Reporting Council, Corporate Culture and the Role of Boards: Report of Observations, July 2016.

## Clarify the board's role in overseeing culture—recognizing that visibility is a major hurdle.

In overseeing culture, an important role for the board is to regularly assess and monitor corporate culture. This requires looking beyond the "corporate values" posted in the lunchroom and understanding the unwritten rules as to how things get done; there is often a disconnect between the corporate values and how employees live them. Roundtable participants agreed that one of the biggest challenges for boards in overseeing culture is visibility. The board should have visibility to the tone at the top, but the culture in the middle and bottom is key and difficult for boards to assess—i.e., visibility is a major hurdle.[4]

"Because directorship is a part-time job, it's hard to feel the culture on a daily basis," one commenter noted. "It's important that boards ask management to help the board understand the culture throughout the organization—the top, middle, and bottom."

"It's also important to look at different segments of the population—not just top to bottom," another attendee observed. "There may be pockets of discontent."

Directors discussed the importance of using a variety of methods to gain a better understanding of the corporate culture. Some common methods include:

- Employee surveys
- Visiting company facilities and talking to employees below senior management
- Input from internal and external auditors
- Whistleblower hotline reports
- Customer complaints
- Walking the halls of corporate headquarters
- Monitoring social media
- Reviewing a dashboard of leading and lagging indicators of culture and conduct.

"Use multiple ways to gauge culture, not just one. You need to look at all of these pieces," a director said.

Even in highly centralized organizations, data related to culture is often collected and tracked by a number of different functions, including legal, internal audit, finance, risk management, human resources, ethics and compliance, and customer service. Further complicating matters, in large, dispersed organizations, valuable information may exist at the local, divisional, or regional levels.[5]

Several participants said culture dashboards can be helpful for providing an integrated picture of the organization's culture. The NACD report contains a sample dashboard (see p. 6), which includes cultural indicators such as customer satisfaction data, human resources and employee data, ethics and compliance data, historical performance and geo-mapping. One director recommended that, if your company doesn't have a culture dashboard, ask that a team of executives from internal audit, compliance, and human resources assemble a dashboard. "Just as we saw with cybersecurity dashboards several years ago, we would expect culture dashboards to evolve over time to provide a better, and better integrated, view of the organization's culture."

One CEO noted that his board looks at a culture dashboard and a conduct dashboard quarterly. "The culture dashboard tracks what employees and customers tell us. The conduct dashboard looks at daily actions. How many complaints have we gotten? How many breaches of policy were there? What were the consequences?"

Participants also emphasized the importance of drilling down on red flags, such as outsized performance. "If you are doing better than all of your competitors, you should ask, 'Why are we doing so well?'" Others warned to watch for unrealistic corporate stretch goals and behavior that goes unchallenged. "What are the consequences of failure? No harm, no foul is not acceptable."

**"Don't let strong performance by the company or a top executive cloud the board's focus on culture. Good results generated by the wrong behaviors are not sustainable."**

"Beware of the absence of complaints...no organization is perfect, and the absence of problems may signal a culture of intimidation."

## Assess where culture belongs on the board and committee agendas.

Where is culture on the board agenda? How is it discussed? As we heard during the roundtable discussions, some boards address culture as a stand-alone agenda item, while others say that they actively discuss and address values, behavior, and culture in a more integrated way, for example, as part of discussions about strategy, risk, customer and employee feedback, compensation policies, health and safety incident reports, customer service, dealings with suppliers and agents, etc. Participants identified several key areas of board focus, including:[6]

- Is the culture really aligned with strategy? Does the culture encourage the values and behaviors that best deliver value creation over the short, medium, and long term? What role does culture play in the performance—or under performance—of the business?
- Do the CEO and management view culture as a key enabler, the differentiator, and source of competitive advantage? Do they understand the importance of culture to the successful execution of strategy?
- CEO and leadership succession and talent development are key ways in which the board helps shape culture.

Determining the most effective ways to discuss culture may be a "journey" for many boards—perhaps at the outset, including culture as a discrete agenda item and also integrating culture into discussions about strategy, risk, and performance. As the board's discussions mature, perhaps there is no longer a need to discuss culture as a separate agenda.

"Our board has dedicated agenda sessions on culture quarterly where they review the culture dashboard and the conduct dashboard," noted one CEO. "When management leaves the room, the directors discuss whether we're measuring it the right way. Then they give the CEO their view on how they think we are doing."

And in certain circumstances, such as a merger or acquisition, a culture failure, or where the company is undertaking a major strategic shift that requires a cultural change, culture may need to be discussed as a discrete agenda item.

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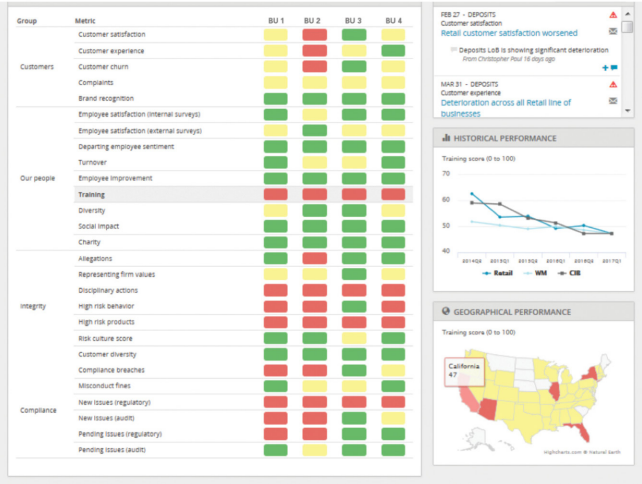
[4] NationalAssociationofCorporateDirectors,ReportoftheBlueRibbonCommissiononCultureasaCorporateAsset,"2017andAnderson,etal.,"LeadingWithCulture."

[5] NACD, BRC Report on Culture as a Corporate Asset.

[6] NACD, BRC Report on Culture as a Corporate Asset and Anderson, Anderson, and Lee, "What Do Boards Need to Know About Culture?"

[7] NACD, BRC Report on Culture as a Corporate Asset.

## NACD Example of a culture-measurement dashboard




**Source:** *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset*, p. 65, 2017

While ultimate responsibility for culture oversight lies with the full board, key committees also have important oversight responsibilities for certain aspects of culture. For example:[7]

### Audit committee:

- Results of internal and external audits
- Ethics and compliance
- Whistleblower hotline
- ICOFR and controls around key operational and compliance risks
- Tone at the top and culture in finance organization

### Compensation committee:

- Alignment of incentives with culture
- Risks posed by incentives
- CEO and senior management evaluations
- Talent strategy

### Nominating/governance committee:

- Board governance policies
- Succession planning for CEO, senior management, and board
- Board composition, diversity, and independence
- Board and individual director performance evaluations

## Keeping culture front and center in the boardroom

**Where is culture on the board and committee agendas? Is it a priority, with clear roles for the board and key committees?**

**Does the CEO set the tone needed to achieve the desired results?**

**Does the culture encourage the behaviors essential to the execution of the company's strategy?**

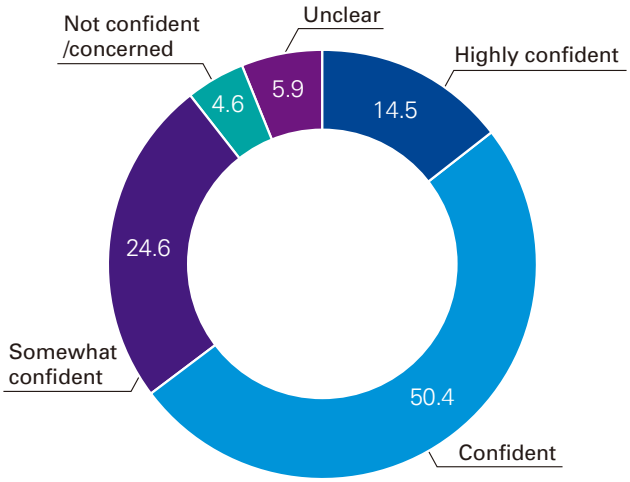
**Are we sensitive to critical alignments—purpose, values, strategy, culture, controls, and incentives?**

**Does management provide the board regular assessments of culture? Could internal audit add more value in its assessment of culture?**

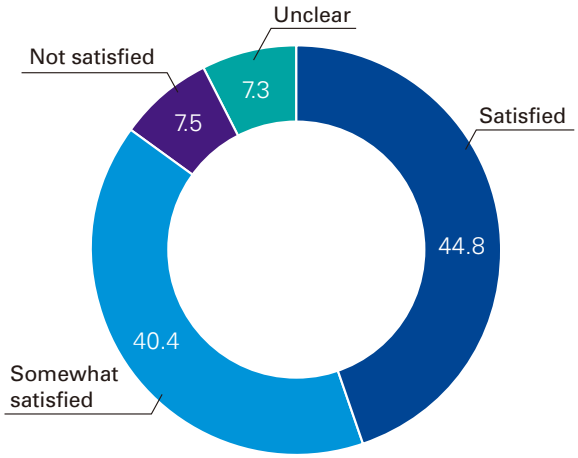
**Does the board integrate culture into its ongoing discussions about strategy, risk, and performance, emphasizing the way performance is achieved?**

**Do directors review the culture of the board and its key committees on a regular basis?**

## How confident are you that the company's actual culture —including the "unwritten rules" for how things get done day-to-day—reflects its stated culture or corporate values?



**How satisfied are you that your board has a good understanding of whether the company's culture encourages behaviors essential to execution of its strategy?**




Based on responses from 560 KPMG Director Roundtable registrants

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

Find more from Board Leadership Center on corporate culture and the board at kpmg.com/blc

**Questions?**

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

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JP Executive Insight

U.S. business update for Japanese companies

# Digital Health and Disruption in Diabetes

## Executive Summary

**Digital Health is a term that has been used in so many different contexts, the definition has become blurry. We have come to define it as the combination of healthcare, life sciences and technology capabilities to fill unmet needs in the patient journey.**

**Looking at the issue a little more closely, the digital health landscape already consists of a set of players with varying capabilities who address some, but not all, aspects of patient wellness and healthcare. As the web of digital health participants evolves and becomes more complex, the race will be on to devise new ways to achieve better patient outcomes, reduce healthcare spend and improve customer experiences. Life sciences companies are well-positioned to identify those digital health opportunities that most closely align with not only patients' needs, but their own long-term growth objectives. (For KPMG's Digital Health Ecosystem Framework, please refer to the chart on page 15.)**

**Although we will explore how digital health solutions can impact other disease states in upcoming publications, our first case is diabetes for a number of reasons:**

- **Both Type One and Type Two Diabetes are chronic conditions.** As such, there are many unmet patient needs throughout the lifecycle from awareness and diagnosis to acute care and long-term lifestyle and health management.
- **Diabetes affects a large population,** so there are significant opportunities to improve patient outcomes and quality of life.
- **Despite many established drugs, devices and technologies,** diabetes remains a condition where patients are still searching for differentiated solutions.

This paper and those that follow are intended to serve as guides for life sciences organizations seeking to determine where the opportunities and threats lie as digital health becomes more mature and ubiquitous. As reflected in KPMG's 2018 CEO Outlook Survey, the idea of disrupting the disruptors has taken hold in all industries, with more than half of CEOs actively disrupting the sectors in which they operate, rather than waiting to be disrupted by competitors.[1] It is critical that life sciences companies seize opportunities to build, buy or partner to create digital health solutions that span the patient journey, before they are overtaken by technology leaders seeking to do the same.

For more information, download the full report below.

**Download Now**

**Digital Health and Disruption in Diabetes >** (PDF/1.3MB)

https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/10/jnet-2018-issue4-article4-DigitalHealthAndDisruptionInDiabetes.pdf

**Questions?**

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

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# JP Executive Insight

**U.S. business update for Japanese companies**

## Auditing & Accounting Update

In this section of JP Executive Insight, we provide a summary of brief updates from the previous quarter 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

October 2018

**Segment Reporting Handbook**

KPMG's newest Handbook is a comprehensive guide to segment reporting – with detailed Q&As and examples that explain key concepts and the challenges faced by preparers and investors. This guidance also includes segment considerations for both domestic filers and foreign private issuers applying IFRS or other GAAP.

Segment Reporting Handbook (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/handbook-segment-reporting.pdf

September 28, 2018

**EITF reaches a consensus-for-exposure on contract liabilities in business combinations**

Defining Issues 18-22 reports that EITF reached consensuses-for-exposure on contract liabilities in business combinations and development costs of episodic TV series.

Defining Issues 18-22 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-22-eitf.pdf

September 21, 2018

**SEC provides regulatory relief for hurricane victims**

Defining Issues 18-21 reports on the SEC's recent orders and interim final temporary rule that extend filing deadlines for companies affected by Hurricane Florence and Michael. The revised deadline is October 29, 2018 for any filing due on or after September 14, 2018.

Defining Issues 18-21 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-21-sec-hurricane.pdf

August 30, 2018

**FASB issues ASU on accounting for implementation costs of cloud computing arrangements**

Defining Issues 18-19 reports on the FASB's new ASU on customers' accounting for implementation costs in cloud computing arrangements (CCAs) based on a consensus of the FASB's Emerging Issues Task Force (EITF). Under the new guidance, implementation costs incurred by customers in CCAs are deferred if they would be capitalized by customers in software licensing arrangements under the internal-use software guidance.

Defining Issues 18-19 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-19-cloud-computing.pdf

August 30, 2018

**The FASB amends fair value disclosure requirements**

Defining Issues 18-20 reports on the FASB's amended fair value disclosures in ASU 2018-13. These changes aim to improve the overall usefulness of disclosures to financial statement users and reduce unnecessary costs to companies when preparing the disclosures.

Defining Issues 18-20 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-20-framework-fair-value.pdf

August 29, 2018

**FASB amends defined benefit plan disclosures**

Defining Issues 18-18 reports on ASU 2018-14 and examines amendments to disclosures for defined benefit pension and other postretirement benefit (OPEB) plans. The amendments aim to improve the overall usefulness of disclosures to financial statement users and reduce unnecessary costs to companies when preparing the disclosures.

Defining Issues 18-18 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-18-fasb-framework-pensions.pdf

August 24, 2018

**SEC simplifies and updates disclosure requirements**

Defining Issues 18-17 reports that the SEC has adopted a rule to update and simplify certain disclosure requirements for the benefit of investors and issuers. The rule amends Regulations S-X, S-K, M-A, and AB as well as the Securities Act, the Exchange Act and the Investment Company Act.

Defining Issues 18-17 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-17-sec-disclosures.pdf

August 17, 2018

**ASU 2018-12 changes how insurance entities recognize, measure, present and disclose long-duration contracts**

Defining Issues 18-16 reports on ASU 2018-12, which changes how insurance entities recognize, measure, present and disclose long-duration contracts. Insurance entities should begin analyzing the implications of the standard throughout their organization.

Defining Issues 18-16 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/di-18-16-long-duration-insurance-accounting-model.pdf

August 9, 2018

**SEC proposes changes to disclosures in certain registered debt offerings**

Defining Issues 18-15 reports that the SEC has proposed amendments to financial disclosures for guarantors and issuers of guaranteed securities and affiliates whose securities collateralize issuers' securities.

Defining Issues 18-15 (PDF)
https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/defining-issues-18-15-sec-registered-debt.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.

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# JP Executive Insight

**U.S. business update for Japanese companies**

## Tax Update

In this section of JP Executive Insight, we provide a summary of brief updates from the previous quarter on legislative, judicial, and administrative developments in tax that may impact Japanese companies operating in the United States.

October 12, 2018

### KPMG report: Initial impressions of proposed GILTI regulations

Proposed regulations (REG-104390-18) relating to the "global intangible low-taxed income" (GILTI) provisions under the new U.S. tax law were published this week in the Federal Register.

Read text of the proposed regulations [PDF 389 KB] (40 pages)

The following discussion provides initial impressions and observations about the proposed regulations under the GILTI provisions.

#### Overview

The proposed GILTI regulations were shorter than many anticipated because Treasury and the IRS limited the scope to address primarily the calculation of the GILTI inclusion amount.Among those things not addressed in the proposed regulations are:

- Rules relating to the section 250 deduction.
- Foreign tax credits, including rules under sections 904 and 960(d).

However, the preamble clarifies an outstanding issue by indicating that "[i]t is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the section 78 gross-up attributable to foreign taxes deemed paid under section 960(d) to the separate category described in section 904(d)(1)(A)."

- Interaction with interest limitation rules under section 163(j) or with hybrid instruments under section 267A (although these issues, along with the dividends received deduction under section 245A, are specifically identified in the preamble as the subject of future guidance).
- Previously taxed income under section 959 or basis adjustments under section 961.
- The interactions of the section 962 election (which generally allows individual shareholders to elect the benefit of corporate rates and indirect foreign tax credits at the cost of a second level of U.S. tax when previously taxed earnings are eventually distributed) and the GILTI regime. In particular, no guidance was provided as to whether the section 250 deduction would be available in computing the hypothetical corporate tax under section 962(a)(1).

TaxNewsFlash - October 12, 2018
https://home.kpmg.com/us/en/home/insights/2018/10/tnf-kpmg-report-initial-impressions-of-proposed-gilti-regulations.html

[Related article (September 13, 2018)]

### Proposed regulations under GILTI provisions (text of regulations)

The U.S. Treasury Department and IRS this afternoon released proposed regulations as guidance relating to the "global intangible low-taxed income" (GILTI) provisions under the new U.S. tax law.

A related IRS release (IR-2018-186) states that:

- The proposed regulations describe new reporting rules requiring the filing of Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income.
- The new law applies to the first tax year of a controlled foreign corporation (CFC) beginning after December 31, 2017, and the U.S. shareholder's year with or within which that year ends, and all subsequent tax years.
- The proposed regulations do not include foreign tax credit computational rules relating to global intangible low-taxed income, and that these rules will be addressed separately in the future.

Treasury and IRS have requested comments on these proposed regulations.

TaxNewsFlash No. 2018-367 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/09/18367.pdf

October 9, 2018

## New Jersey: Corporation business tax law changes enacted

New Jersey's governor on October 4, 2018, signed the following legislation:

- Assembly Bill 4495 [PDF 616 KB] containing both technical corrections and substantive changes to the Corporation Business Tax (CBT) Act, as revised earlier this year
- Assembly Bill 4496 [PDF 380 KB] establishing an economic nexus threshold for remote sellers and requiring certain marketplaces to collect tax on sales they facilitate (effective November 1, 2018)

The legislation includes measures to revise the effective dates for mandatory combined reporting and market-based sourcing; dividends-received deduction changes; related-party expense addback changes; rules concerning the taxation of GILTI and FDII-determined amounts of income; and maximum tax rules under combined reporting.

The legislation also represents the state's legislative response to the decision of the U.S. Supreme Court in *South Dakota v. Wayfair, Inc.* by establishing an economic nexus threshold for remote sellers and by imposing a requirement on certain electronic and physical marketplaces to collect sales tax on sales that they facilitate. The measures are effective November 1, 2018.

TaxNewsFlash No. 2018-424 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/10/18424.pdf

October 3, 2018

## Notice 2018-76: Transitional guidance on deductibility of business meal expenses

The IRS today released an advance version of Notice 2018-76 as guidance on the deductibility of expenses for certain business meals under section 274 as amended by the new U.S. tax law.

Notice 2018-76 [PDF 35 KB] explains that the new tax law (Pub. L. No.115 -97, enacted December 22, 2017) amended section 274 to generally disallow a deduction for expenses for entertainment, amusement, or recreation. The new tax law, however, did not specifically address the deductibility of expenses for business meals.

Notice 2018-76 provides:

- Transitional guidance on the deductibility of business meals
- The IRS and Treasury Department intend to issue proposed regulations that will include guidance on the deductibility of expenses for certain business meals
- Taxpayers may rely on this guidance for the treatment of business meal expenses until the proposed regulations are issued

TaxNewFlash No. 2018-408 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/10/18408.pdf

September 24, 2018

## The New Section 163(j): Selected issues

### Introduction

On December 22, 2017, H.R. 1 (originally known as the Tax Cuts and Jobs Act of 2017) was signed into law (the "Act"). As part of the Act, Code section 163(j) was amended to create a broad deferral/disallowance regime with respect to the deductibility of "business interest expense." Judging by the numerous drafting mistakes that the IRS has all but acknowledged, it appears that new section 163(j) was rushed into law without a full and careful review. Thus, it will be the job for years to come of the IRS, the courts, and tax practitioners to grapple with and work out the numerous problems and mistakes of the new statute.

### Selected Issues

*A. General*

Section 163(j) was amended by the Act to provide new rules limiting the deduction of "business interest expense" ("BIE") for tax years beginning after December 31, 2017. Section 163(j) now provides that a taxpayer (including individuals and corporations) generally will be prohibited from deducting BIE in excess of the sum of its:

- Business interest income ("BII"),
- 30 percent of "adjusted taxable income" ("ATI") from a trade or business, as further described below, and
- Floor plan financing interest for the tax year.

BIE is interest expense, and BII is interest income, that are properly allocable to a "trade or business," but not investment interest expense or income under section 163(d).

Any disallowed interest may be carried forward indefinitely. However, unlike old section 163(j) (which allowed the carryforward of unused excess limitation, see below), unused ATI may not be carried forward to increase the ATI of the taxpayer in a subsequent tax year.

*B. Carryforwards under Old Section 163(j)*

Prior to the Act, section 163(j) disallowed a deduction for disqualified interest paid or accrued by a corporation in a tax year if two threshold tests were satisfied. The first threshold test was satisfied if the payor's debt-to-equity ratio exceeded 1.5 to 1.0. The second threshold test was satisfied if the payor's net interest expense exceeded 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion).

Clearly, new section 163(j) would not permit the use of any "excess limitation carryforwards" from pre- Act years to post-Act years as new section 163(j) expressly limits the use of BIE to 30 percent of the current ATI of the taxpayer. But upon enactment the question arose, what happens to the interest expense carried forward under prior section 163(j) to post-Act years?

On April 2, 2018, the IRS issued Notice 2018-28 (the "Notice") which stated that Treasury and the IRS intend to issue regulations clarifying that taxpayers with disqualified interest disallowed under prior section 163(j) for the last tax year beginning before January 1, 2018, "may carry such interest forward as business interest to the taxpayer's first tax year beginning after December 31, 2017." Also, the regulations will clarify that the interest carried forward will be subject to potential disallowance under new section 163(j) "in the same manner as any other business interest otherwise paid or accrued" in a tax year beginning after December 31, 2017.

*C. Corporations*

1. Investment Interest

Section 163(j) applies only to the deduction of "business interest," which is defined as, "any interest paid or accrued on indebtedness properly allocable to a trade or business." It does not include "investment interest (within the meaning of subsection (d))." Section 163(d)(3)(A) defines "investment interest" as "any interest allowable as a deduction under this chapter…which is paid or accrued on indebtedness properly allocable to property held for investment."

Consider a corporation that pays interest on indebtedness properly allocable to property held for investment. Should this interest be subject to the interest limitation rule of section 163(j) or would it escape the limitation, as it is not business interest? Although the limitations of section 163(d) on the deductibility of investment interest do not apply to corporations, section 163(d) makes no affirmative reference as to whether it is possible for corporate taxpayers to have "investment interest" and section 163(j) provides no express provision addressing this question.

2. Consolidated Groups

The Notice states that Treasury and the IRS intend to issue regulations clarifying that the limitation in section 163(j)(1) on the amount allowed as a deduction for business interest applies at the level of the consolidated group and therefore, for example, it is the group's ATI and the group's interest expense and income (ignoring intercompany liabilities) that is used in applying section 163(j).

3. Earnings and Profits

The Notice also states that Treasury and the IRS intend to issue regulations clarifying that the disallowance and carryforward of a deducti on for a C corporation's BIE under section 163(j) will not affect whether or when the BIE reduces earnings and profits (E&P) of the payor C corporation. Indeed, this was the approach taken under proposed section 1.163(j)-1(e) and 1.163(j)-8(g) for prior section 163(j).

*D. Electing Real Estate Trade or Business*

A taxpayer may elect to be excluded from the interest deduction limitations of section 163(j) if the taxpayer is engaged in a "real property trade or business" under section 469(c)(7)(C). If the election is made it is irrevocable. While this election can yield significant benefits to a taxpayer, there is a price to pay for it—if a taxpayer makes the election, the taxpayer must depreciate nonresidential real property, residential rental property, and qualified improvement property under the ADS recovery period, i.e., longer lives and slower depreciation. For example, residential rental property placed in service before 2018 would convert to an ADS life of 40 years. Thus, when determining whether to make the election, taxpayers engaged in a real property trade or business will have to weigh the benefit of no section 163(j) interest limitation versus the cost of slower depreciation deductions.

The election to opt out of section 163(j) for taxpayers engaged in a real property trade or business may provide taxpayers with interesting planning alternatives, assuming there are sufficient business purposes to support the planning.

*E. Interest Equivalents*

Section 163(j) literally only applies to "interest," thereby creating an opening for taxpayers to avoid the limitations of section 163(j) by incurring liabilities that accrue expense and deductions that are not literally interest. A simple example would be using a securities loan to generate cash proceeds, and to pay deductible "substitute payments" with respect to the securities loan.

What's News in Tax – September 2018 report (PDF)
https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/09/tnf-wnit-sec-163j-sep24-2018.pdf

September 21, 2018

## Notice 2018-75: Employer reimbursements made in 2018 for employee moving expenses in 2017

The IRS today released an advance version of Notice 2018-75 as guidance concerning the tax treatment of employer reimbursements of "qualified moving expenses."

Before the new U.S. tax law, reimbursements made by employers for the qualified moving expense of their employees generally were excludable from an employee's gross income and from wages for employment tax purposes. The new U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017) suspended the exclusion from gross income and from wages for employment tax purposes for qualified moving expense reimbursements for years 2018-2025. [The exclusion was preserved for members of the U.S. Armed Forces and their family members.] The suspension of the income and wage exclusion is effective for tax years beginning after December 31, 2017.

Notice 2018-75 [PDF 47 KB] specifically addresses employer reimbursements made in tax years beginning after December 31, 2017, for qualified moving expenses incurred in connection with a move that occurred before 2018. The IRS notice states that reimbursements received after 2017 for a move made before 2018 will not be subject to the suspension of the income exclusion.

To qualify, the reimbursements or payments must be for work-related moving expenses that would have been deductible by the employee if the employee had directly paid them prior to January 1, 2018. Also, the employee must not have deducted the expenses in 2017.

TaxNewsFlash No. 2018-382
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/09/18382.pdf

September 21, 2018

## Proposed regulations: Removal of section 385 "documentation regulations"

The U.S. Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-130244-17) that would remove from the final regulations under section 385, the documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes—referred to as the "documentation regulations." As such, the proposed regulations would affect corporations that issue indebtedness to related corporations or partnerships.

The proposed regulations [PDF 256 KB] also provide conforming amendments to other final regulations to reflect the proposed removal of the documentation requirements. Comments and requests for a public hearing must be received by 90 days after the publication of these proposed regulations in the Federal Register (scheduled for Monday, September 24, 2018).

The purpose of this report is to provide text of the proposed regulations.

### Background

Final regulations under section 385 were promulgated in October 2016. In general, as part of the final regulations, the "documentation regulations" (that is, certain portions of the regulations relating to the documentation necessary to determine whether an interest in a corporation is treated as stock or indebtedness) were to apply to interests issued, or deemed issued, on or after the date the proposed regulations were finalized.

TaxNewsFlash No. 2018-381 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/09/18381.pdf

September 10, 2018

## KPMG report: State responses to "Wayfair" (IN, MD, NJ, OK, SD)

State governments have continued to issue guidance or statements after the U.S. Supreme Court's decision in "South Dakota v. Wayfair, Inc." as to how the states will apply the decision.

In Wayfair, the U.S. Supreme Court overruled the physical presence nexus standard of Quill and National Bellas Hess with respect to state and local taxation of remote sales. Soon after the Supreme Court issued its decision in Wayfair, various states began issuing guidance or statements or began steps to introduce legislation in response to the decision in the Wayfair case.

More states have responded to the Court's decision or have updated their initial response to the decision.

[Related article: (August 20, 2018)]

## Two more states respond to "Wayfair" decision (NJ, SC)

Two more U.S. states—New Jersey and South Carolina—responded to the U.S. Supreme Court's decision.

TaxNewsFlash No. 2018-327 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/08/18327.pdf

[Related article: (August 13, 2018)]

## More states respond or update initial reactions to "Wayfair" decision (AR, CA, LA, ME, MD, MS, NC, SD, WY)

More states have responded to the Court's decision or have updated their initial response to the decision.

TaxNewsFlash No. 2018-315 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/08/18315.pdf

September 6, 2018

## IRS provides draft version of Form 8991 for "BEAT" reporting

The IRS has posted a draft version of Form 8991 concerning the "base erosion and anti-abuse tax" (BEAT) reporting for 2018.

In an effort to "level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies," the new U.S. tax law (Pub. L. No. 115- 97, enacted December 22, 2017) created a new base erosion-focused minimum tax— the base erosion and anti-abuse tax (BEAT)—that in many instances would significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinational entities. The BEAT includes within its scope almost every outbound payment made by corporations subject to the rule, except for payments treated as costs of goods sold (COGS) or otherwise as reductions to gross receipts (subject to regulatory authority from the Treasury Secretary for anti-avoidance regulations). This limited exception is unavailable for taxpayer groups that "invert" after November 9, 2017. Other than for such inverted groups, the BEAT does not apply, for example, to payments for inventory manufactured outside the United States.

Read the draft version of Form 8991 [PDF 162 KB], *Tax on Base Erosion Payments of Taxpayers With Substantial Gross Receipts*

The draft version of Form 8991 has a "watermark" date of September 5, 2018, and includes cautionary language that it is not to be used for filing purposes, and is subject to change and to OMB approval before being officially released.

TaxNewsFlash No. 2018-354 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/09/18354.pdf

September 5, 2018

## IRS provides draft versions of Form 965 and Schedule H

The IRS posted an "early draft release" of two forms that, if finalized, would be used to report information about the "transition tax" imposed under section 965.

Section 965 was added to the Code by the new U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017) as a transition rule to effect the participation exemption regime. The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's "mandatory inclusion" amount at a rate of 15.5% to the extent it is attributable to the shareholder's aggregate foreign cash position or otherwise at a rate of 8%.

The draft forms reflect a "watermark" date of August 30, 2018, and include cautionary language that they are not to be used for filing purposes, and are subject to change and to OMB approval before being officially released.

TaxNewsFlash No. 2018-350 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/09/18350.pdf

August 21, 2018

### Notice 2018-68: Guidance on deduction limitation for remuneration paid to "covered employee" under section 162(,) (new tax law)

The IRS released Notice 2018-68 as initial guidance on the application of section 162(m)—as amended by the new U.S. tax law—concerning the allowable deduction for remuneration paid by any publicly held corporation with respect to a "covered employee." The notice provides a transition rule applicable to certain outstanding arrangements (referred to as the "grandfather rule"). Note, the definition of a "publicly held corporation" is expanded to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs.

TaxNewsFlash No. 2018-329 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/08/18329.pdf

August 21, 2018

### New FAQ for QI / WP / WT

The IRS: (1) published a new "frequently asked question" (FAQ) as guidance for qualified intermediaries / withholding foreign partnerships / withholding foreign trusts (QI/WP/WT); and (2) issued a reminder to all QI/WP/WT entities with a certification period ending in 31 December 2017 to log into the QI/WP/WT Application and Account Management System to select the periodic review year of their certification period by 1 September 2018.

TaxNewsFlash – August 21, 2018
https://home.kpmg.com/us/en/home/insights/2018/08/tnf-united-states-new-faqs-for-qi-wp-wt0.html

August 10, 2018

### Proposed bonus depreciation regulations and 2018 filing season: Opportunities and pitfalls

The U.S. Treasury Department and IRS on August 3, 2018, released for publication in the Federal Register proposed regulations (REG-104397-18) implementing changes to the additional first-year depreciation deduction ("bonus depreciation") that were enacted as part of the new tax law in the United States, Pub. L. No. 115-97 that is sometimes referred to as the Tax Cuts and Jobs Act ("Act").

The proposed regulations clarify a number of areas that were left unclear from the statute, including when qualified property is "acquired," when "used" property will be eligible for bonus deprecation, and how the new rules apply in the context of partnership items, such as those arising in the context of sections 704(c), 732, 734(b), and 743(b).

TaxNewsFlash No. 2018-311 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/08/18311.pdf

August 1, 2018

### Text of regulations, Section 965 "transition tax"

The U.S. Treasury Department and IRS on August 1, 2018 released proposed regulations (REG104226-18) relating to the "transition tax" under section 965—as added to the Code by the new tax law (Pub. L. No.115-97) enacted in December 2017.

Section 965 imposes a transition tax—one that requires a mandatory deemed repatriation of previously untaxed earnings. Under this provision, a 15.5% rate applies to earnings attributable to liquid assets, and an 8% rate applies to earnings attributable to illiquid assets.

According to a related IRS release (IR-2018-158), taxpayers may generally elect to pay the transition tax in installments over an eight-year period under section 965(h). The proposed regulations contain detailed information on the calculation and reporting of a United States shareholder's section 965(a) inclusion amount, as well as information for making the elections available to taxpayers under section 965.

TaxNewsFlash No. 2018-311 (PDF)
https://assets.kpmg.com/content/dam/kpmg/us/pdf/2018/08/18311.pdf

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**Questions?**
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