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A Preview of Treasury's Approach to the Digitalized Economy?

On August 9, 2019, Treasury and the Internal Revenue Service released two sets of regulations -- long-awaited proposed regulations on cloud transactions and proposed regulations on transactions involving digital content. Generally, the cloud transactions proposed regulations classify a cloud transaction as either a provision of services or a lease of property. Prop. Reg. §1.861-19. Treasury provided a non-exhaustive list of factors in making such determination. Although certain cloud transactions may have characteristics of both a lease of property and the provision of services, such transactions are classified as one or the other and not bifurcated into a lease and separate service transaction. If, however, the arrangement involves multiple cloud transactions, then a separate classification is made for each transaction (except any transaction that is de minimis).

The proposed regulations on transactions involving digital content contain a source rule for sales of copyrighted articles through an electronic medium. Prop. Reg. §1.861-18. The final regulations under 1.861-18, issued in 1998, included only a general reference to the title passage rule for the sale of computer programs through electronic downloads. The title passage rule provides that a "sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer." Treas. Reg. §1.861-7(c). Since 1998, Treasury and the IRS have become aware of the uncertainty in applying the title passage rule to sales of copyrighted articles, such as electronically downloaded software. In the preamble to the proposed regulations, Treasury and the IRS wrote:

> In many sales of copyrighted articles, the location where rights, title, and interest are transferred is not specified. In some cases, due to intellectual property law concerns, there may be no passage of legal title when the copyrighted article is sold.

In addition, Treasury and the IRS noted that the location of the transfer could be easily manipulated. For example, the server location from which the copyrighted article is downloaded could be in almost any jurisdiction in the world.

Treasury and the IRS have proposed an addition to the title passage rule, which provides that when a copyrighted article is sold and transferred through an electronic medium, the sale is deemed to occur at the location of download or installation onto the end-user's device used to access the digital content. If there

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Miami
►September 26, 2019

European Tax Trends, Risks and Outlook

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►October 1, 2019

Dallas
►October 2, 2019

Miami
►October 3, 2019

New York
►October 7, 2019

13th Annual Transfer Pricing Seminar

Mexico City
►October 8, 2019

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is an absence of information about the location of the download or installation onto the end-user's device used to access the digital content, then the sale is deemed to occur at the customer's location. The income from sales or exchanges of copyrighted articles is sourced under Code Sections 861(a)(6), 862(a)(6), 863 or 865(a), (b), (c) or (e), whichever is appropriate.

To illustrate the proposed rule, assume a US vendor operates a website that offers electronic books for download onto end-users' computers or other electronic devices. The books are protected by copyright law. The US vendor charges a fixed-fee for each book purchased. The place of sale is deemed to occur at the location of the download, e.g., where the customer is located. If the customer is located in a foreign country and if the appropriate source rule is section 862(a)(6) (assuming electronic books are not produced and can be categorized as inventory), then the income would be foreign source and would go into the general basket for foreign tax credit purposes. If the US vendor had excess credits in the general basket, the foreign source income could help free up the credits. The proposed rule could be quite favorable.

In the inbound context, assume a foreign vendor sells electronic books for download charging a fixed-fee for each book. The books are protected by copyright law. If the customer is located in the United States and if the appropriate source rule is section 861(a)(6), then the income would be United States source. If the foreign vendor has a US trade or business, the US source income would be effectively connected to a US trade or business and subject to US tax. This could be a surprising result to the foreign vendor, particularly if the vendor is located in a country that does not have a tax treaty with the United States so as to be unable to rely on the absence of a permanent establishment.

The Organisation for Economic Co-operation and Development ("OECD") has been developing a proposal for a consensus solution to the tax challenges arising from the digitalization of the economy. To date, the OECD proposals are grouped into two pillars, which could form the basis for consensus:

> Pillar One: allocation of taxing rights and a review of the profit allocation and nexus rules.
>
> Pillar Two: provide jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or the income is subject to a low effective tax rate.

Pillar One has been broken into down three proposals: "user participation," "marketing intangibles," and "significant economic presence." Although there are substantial differences in the three proposals, they all allocate more taxing rights to the jurisdiction of the customer or user (i.e., the "market jurisdictions"), in situations where value is created by business activity in that jurisdiction. Treasury and the IRS's proposed rule on sourcing of sales of copyrighted products through an electronic medium seems to be consistent with Pillar One -- focusing on the jurisdiction of the customer or user. By treating the sale as taking place where the customer downloads the digital content (or installs it on the end-user's device), the income may be sourced to the customer's jurisdiction and possibly taxed by that jurisdiction. As previously illustrated in the inbound context (foreign vendor selling digital content through an electronic medium to a US customer), the income may be US source (if section 861(a)(6) is the appropriate source rule) and could be effectively connected to a US trade or business. If so, the US will tax such income, due to the customer downloading (or being located) in the US, unless a tax treaty is applicable.

By Joshua Odintz, Alexandra Minkovich, Washington, DC and Christopher Hanna, Dallas

Schneider Electric Victory

In the Tax Court, the IRS challenged the allocation of Code Section 45 credits and deductions stemming from Schneider Electric's ("Schneider") investment in a partnership created to refine coal. The critical questions were, first, whether Cross Refined Coal LLC ("Cross") was a bona fide partnership, and second, whether Schneider and the other members of the partnership, Fidelity Investments ("Fidelity") and Arthur J. Gallagher & Co., were bona fide partners. In a rare set of circumstances for a case of this size, Judge David Gustafson issued a bench opinion at the end of trial. The bench opinion, which Judge Gustafson read on August 14, concluded that Schneider, along with the other members, were bona fide partners entitled to their claimed credits and deductions.

The case, *USA Refined Coal LLC v. Commissioner*, Dkt. No. 19502-17, was a bit unusual in that the facts for each of the three partners were different and, as a result, required an independent analysis for each. USA Refined Coal LLC (an LLC owned by both Fidelity and Arthur J. Gallagher) was the tax matters partner, while Schneider was a participating partner in the case due to its involvement in the Cross refined coal facility at issue.

The Facts

In 2004, AJ Gallagher, through a wholly-owned entity called AJG Coal, Inc. ("AJGC"), invested in chemical technology used to produce refined coal through a company called Chem-Mod. AJGC helped to license the technology, and in 2009, AJGC sub-licensed the technology to producers in the refined coal industry in return for royalties. AJGC also participated directly in the production of refined coal, and thus received both royalties from the technology as well as the tax credits of section 45.

AJGC's business model for these refined coal production facilities required a relationship with a utility company that generated electric power by burning coal. AJGC entered into a contract to purchase raw coal from the utility company and then later sell back the refined coal to the utility company. This business model required AJGC to build a coal-refining facility on the premises of the utility company.

The utility company that was involved in the purchase of refined coal with AJGC faced significant risks. Burning refined coal is a complex and costly process which required complicated engineering and risks to the facility's equipment. Further, the Chem-Mod technology was new, and its long-term impact on the coal and equipment was uncertain. Thus, to incentivize the utility company to take on this risk, AJGC offered a discounted rate at which the utility would purchase back the refined coal. As such, the utility company sold the raw coal at a price higher than the refined coal it later purchased back from the refiner. In other words, the transaction was guaranteed a pre-tax loss to the refiner.

As a part of the American Jobs Creation Act of 2004, Congress expanded section 45 to provide tax credits for the production of refined coal that is "produced" and "sold to an unrelated person" in a 10-year period, provided that the refined coal meets certain emissions reduction requirements. Prior to 2008, section 45 required refined coal to be sold for a profit. However, in the Energy Improvement and Extension Act of 2008, Congress recognized that the industry did not allow for a pre-tax profit and eliminated this requirement to incentivize refined coal production.

Because of the significant risks related to the business of refined coal, AJGC sought to diversify its investments among multiple investors and multiple refined coal production plants. One of these facilities was the Cross Generating Station ("Cross") located in Pineville, South Carolina. In the Cross refined coal facility at issue, AJGC partnered with Fidelity and Schneider.

Before Schneider and Fidelity joined the partnership, each undertook significant due diligence with respect to operational risks, the financial aspects of the project, and the reliability of the other partners to assure the appropriateness of the investment. This process involved teams of professionals, both in-house and third-party, to evaluate the refined coal process for all possible discoverable and quantifiable risks. Despite the significant risks involved in this industry, the project was projected to yield significant returns, dependent on the section 45 credits.

On March 1, 2010, Schneider purchased from AJGC a 25% direct interest in Cross and two other refined coal partnerships for a total of $4.25 million, $1.8 million of which was attributable to Cross. Within the terms of the operating agreement, each member of Cross was required to pay its share of ongoing operating costs of the facilities. This included an upfront amount that Schneider placed in escrow from which the partnership could pay for expenditures. At the outset, Schneider's share of this escrow account was $1.18 million, $496,000 of which was attributable to the Cross facility. Over the next few years before its exit from the partnership, Schneider ultimately paid more than $10.5 million in additional capital contributions.

Per the terms of the agreement, Schneider also owed to AJGC a "Finder's Fee" to compensate AJGC for its time and effort spent on the research and development of the refined coal technology. Schneider and Fidelity also paid a royalty to AJGC dependent on the operating expenses of the facility – as expenses increased, the royalty to AJGC decreased. Fidelity's agreement with AJGC also included a liquidated damages provision which allowed Fidelity to leave the partnership upon the occurrence of various triggers. Schneider's agreement with AJGC did not include a liquidated damages provision.

The Cross facility operated from 2010 to 2013. By the time of the members' exit from Cross, the facility had generated after-tax profit, including the benefits of the refined coal tax credits, totaling almost $19 million, shared among the three partners. Nonetheless, this benefit fell well below the expected benefit for the same period. Between 2010 and 2013, the Cross facility faced significant operational issues that impeded or completely halted production for various lengths of time.

In mid-2012, Schneider determined that the refined coal partnerships required additional supervision. Without the resources available for this purpose, Schneider asked AJGC whether it had interest in buying Schneider's share of the partnership. On March 1, 2013, after months of negotiation, AJGC purchased back Schneider's interest Cross and the other facilities in which Schneider was involved. As to Cross, the arrangement included a $25,000 payment and forgiveness of an unrelated note.

The Opinion

At issue was whether Schneider and Fidelity were partners in Cross and thus entitled to its claimed losses and section 45 credits from its refined coal business. A partnership exists when "parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 US 733, 742 (1949). To make this determination, courts look to the facts and circumstances to determine whether a partner has a "meaningful stake in the success or failure" of the enterprise. *Id*. at 742. The Tax Court, in *Luna v. Commissioner*, has established eight factors to be considered when assessing the business purpose intent of the parties to a purported partnership. 42 T.C. 1067, 1077-78 (1964). In his pretrial memorandum, the Commissioner acknowledged that the parties to Cross satisfied all but two of the eight factors. The two factors at issue to this case were (1) "the contributions, if any which each party has made to the venture," and, (2) "whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income."

With respect to capital contributions, the court recognized Schneider's $1.18 million initial contribution for its interest in Cross and Schneider's additional contributions of $10.6 million for operating expenses in 2010 to 2012. The court also acknowledged, that despite Fidelity's liquidated damages provision, upon its exit, Fidelity received only $2.5 million, leaving behind $1.5 million of its original investment. Ultimately, the court concluded that these contributions were, in substance, investments in equity. In other words, both Schneider and Fidelity were at risk for their initial capital contributions and both Schneider and Fidelity contributed to Cross commensurate with their status as a partners.

As to whether the partners shared in the profits of the venture, the court reasoned that given the nature of the industry and Congress's change to the requirements under section 45, it must look to the post-tax profits that the members anticipated, and found that the parties did, in fact, share in the profits of the venture. The court distinguished the case at issue from *Historic Boardwalk*

Hall, LLC v. Commissioner, 694 F.3d 435 (3d Cir. 2012), rev'g 136 T.C. 1 (2011), where the taxpayer entered into the venture for rehabilitation credits well after the project was established and did not have meaningful downside risk or upside potential. On the facts of this case, the court found that "it is difficult to make a serious case that the members did not share risk and the risk of loss." The court concluded that both Schneider and Fidelity believed that they bore, and that they did in fact bear, risk of loss from the refined coal operation.

Baker McKenzie represented Schneider, while other firms represented the other partners. Baker McKenzie's trial team was led by Dan Rosen and included Jonathan Welbel, Rob Walton, Christina Norman, and Cameron Reilly.

By Cameron Reilly and Christina Norman, Chicago

Ninth Circuit Delivers for Amazon on Interpretation of "Intangible" in 1995 Cost Sharing Regulations

On August 16, 2019, the Ninth Circuit held that the definition of "intangible" in the cost sharing regulations in effect at the time that Amazon.com, Inc. ("Amazon") entered into a cost sharing arrangement excluded residual business assets. *Amazon.com, Inc. v. Commissioner*, 124 A.F.T.R.2d (RIA) (9th Cir. 2019). Based on this determination, the Ninth Circuit affirmed the Tax Court's holding in *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (Mar. 23, 2017), that the IRS was arbitrary, capricious and unreasonable in using a discounted cash flow method to value the buy-in of pre-existing intangibles for a cost sharing agreement arrangement. For additional discussion of the Tax Court's decision, see *Tax News and Developments*, "*Tax Court Rejects IRS's Indefinite Intangible Useful Life in Amazon Transfer Pricing Case, Just Like* VERITAS," (Vol. 17, Issue 3, April 2017).

Amazon entered into the cost sharing arrangement at the center of this dispute as part of a series of transactions it undertook beginning in 2004 to centralize its operations in Europe. Amazon first established a European headquarters entity in Luxembourg ("Amazon Europe") and contributed several of its pre-existing European subsidiaries and the assets of those entities. Amazon and Amazon Europe then entered into the cost sharing arrangement. Amazon also contributed certain pre-existing intangibles necessary to the cost sharing arrangement, and Amazon Europe paid Amazon the "buy-in" payment for those intangibles.

The IRS assessed several deficiencies in relation to the cost sharing arrangement, including that Amazon had substantially undervalued the "buy-in" payment. When the parties brought their dispute to the Tax Court, it largely held in favor of Amazon. The IRS then appealed the Tax Court's decision on the valuation of the pre-existing intangibles that Amazon contributed and the amount of the buy-in payment. The Ninth Circuit observed the difference between the two, noting that Amazon's method "isolated and valued only the specific intangible assets … including website technology, trademarks, and customer lists," and the IRS's method "essentially valued the entire European business [and] necessarily swept into the calculation all contributions of value, including those that are more nebulous and inseparable from the business itself.… .” (The IRS and the Ninth Circuit both referred to these “nebulous” assets as “residual business assets.”)

To resolve this discrepancy in valuations, the Ninth Circuit had to determine whether Amazon should have included the residual business assets in the buy-in valuation. The Ninth Circuit looked at the issue from four different angles, specifically, “the regulatory definition of an ‘intangible,’ the overall transfer pricing framework, the rulemaking history of the regulations, and whether the Commissioner’s position is entitled to deference under *Auer v. Robbins*, 519 US 452 (1997).”

The Ninth Circuit began with the definition of “intangible” in Treas. Reg. §1.482-4(b), and applied the standard rules of statutory construction, which are the same for regulations as for statutes. Under the analysis set forth in *Chevron USA, Inc. v. Nat. Res. Def. Council, Inc.*, 467 US 837 (1984), the first step is to determine whether the language is unambiguous. In this case, the operative provision in the regulations states that an intangible is an asset that has “substantial value independent of the services of any individual” and is included on the list of items in the rest of the definition. The list also contains a catch-all provision that states “similar to those listed in paragraph (b)(1) through (5) … if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.” The Ninth Circuit reviewed the arguments of both Amazon and the IRS regarding the interpretation of this provision, and found neither to be convincing.

Finding the first element of the analysis -- the regulatory definition -- inconclusive, the Ninth Circuit then turned to the remaining three elements, which proved more fruitful for Amazon.

Reviewing the overall framework of the transfer pricing regulations, the Ninth Circuit evaluated the IRS’s arguments that the framework mandates that taxpayers include residual business assets because (1) Treas. Reg. 1.482-7A(g)(1) (the Ninth Circuit follows the practice of the parties of using the citations from the 2009 transfer pricing regulations) requires that a taxpayer includes in the buy-in any assets that “are made available” for the cost sharing arrangement and (2) the preamble to the transfer pricing regulations requires that transactions between related parties clearly reflect income and prevent tax avoidance. These arguments failed to convince the Ninth Circuit, because each provision presupposes that a residual business asset is an intangible. Instead, the Ninth Circuit noted that the overall framework of the transfer pricing regulations favored Amazon, because the cost sharing regulations identify “intangibles as being the product of R&D efforts,” i.e., something that arises from a deduction, rather than an income flow.

The third element of analysis the Ninth Circuit focused on was the drafting history of the transfer pricing regulations. The Ninth Circuit found the regulatory history indicated that the definition of intangible was “limited to independently transferable assets,” which does not include residual business assets. The Ninth Circuit walked through the definition of “intangible” as it developed from 1968 regulations to the 1994 regulations currently at issue, including the addition of

Code Section 936(h)(3)(B) in 1982. The parts of the drafting history that the Ninth Circuit found the most persuasive were *A Study of Intercompany Pricing Under Section 482 of the Code*, I.R.S. Notice 88-123, 1988-2 C.B. 458 (the "White Paper"), and Treasury's response to comments it received on preliminary and temporary versions of the definition in the versions of the regulations Treasury issued following the White Paper. The White Paper recommended that a buy-in agreement include three types of intangibles: "preexisting intangibles at various stages of development that will become subject to the [cost sharing] arrangement," "basic research not associated with any product," and "a going concern value associated with a participant's research facilities and capabilities that will be utilized." The public comments following the White Paper opposed including any going concern value; when Treasury issued proposed regulations in 1993, it did not include any reference to going concern value, and expressly solicited comments on whether the definition of intangibles should be "expanded to include" residual business assets. In addition, while the 1993 proposed regulations did include a "commercially transferable interest" requirement in the definition, the Ninth Circuit found that the elimination of this term from the definition in the final regulations was insignificant to the interpretation, based on the fact that Treasury specifically noted in the preamble that it omitted the term because it considered the extra language "superfluous."

Finally, the Ninth Circuit turned to the question of *Auer* deference, and found that *Auer* deference was not appropriate here. Under *Auer*, a court gives controlling weight to an agency's interpretation of its own regulation if the interpretation is not "clearly erroneous or inconsistent with the regulation." The Ninth Circuit notes that *Auer* deference is limited in scope. First, it only applies if the regulation is genuinely ambiguous. Second, agencies still must provide "fair warning of the conduct" that the regulation prohibits or requires, and the agencies are not entitled to *Auer* deference if the regulation would constitute "unfair surprise." Here, the Ninth Circuit held that regardless of whether the definition of "intangible" in the transfer pricing regulations at issue is ambiguous, the IRS's arguments in this particular case were the first time that the IRS or Treasury had advanced this interpretation of the definition of "intangible." As such, the Ninth Circuit found that Treasury did not give fair warning to taxpayers, including Amazon, of the new interpretation.

On balance, the Ninth Circuit weighed three out of four elements of the analysis in favor of Amazon's position that it need not include residual business assets in the valuation of the pre-existing intangibles. Further, the remaining element was balanced between Amazon and the IRS, and did not change the overall analysis. Therefore, the Ninth Circuit affirmed the Tax Court's holding that the discounted cash flow valuation method used by the IRS was inappropriate.

By Susan Keeler, Palo Alto

Out in the Open: Overseas Entities Owning UK Real Estate Must Reveal Who Owns and Controls Them

From a to-be announced date in 2021, overseas entities that own or want to buy UK real estate will have to supply details of their ultimate beneficial owners for inclusion in a publicly available register. According to the UK Government, the register will be the first of its kind in the world. The purpose of the proposed legislation is to increase transparency with a view to supporting the fight against corruption, tax evasion and money laundering, by preventing people from hiding assets that are ill-acquired or on which they owe tax. The creation of the new register is part of the UK's increased focus on information sharing and corporate transparency, which is consistent with current international trends. There are significant sanctions for failure to comply: as well as restrictions on selling, buying, leasing, or charging UK land, there are potentially unlimited fines and even custodial sentences.

Anti-Corruption: Background

A beneficial ownership register for overseas entities has been in the cards for some years. Progress has been slow, with the principle of improving transparency in relation to overseas entities owning land in the UK being first discussed over three years ago in May 2016. A call for evidence was published in April 2017 and the Government response published in March 2018. The Registration of Overseas Entities Bill was published in July 2018, along with commentary, with a targeted implementation date of 2021. The Joint Committee (the "Committee") (a group of MPs and Lords) responsible for scrutinizing the draft Bill published their report on May 20, 2019. On July 18, 2019, the Government published their response, accepting a number of the Committee's recommendations, but did not give an indication of an exact date in 2021 when the Bill will come into force.

Persons with significant control

It is already the case (since 2016) that, under UK law, nearly all UK companies and Limited Liability Partnerships must keep a register of "persons with significant control" ("PSCs"), and make that register public by filing it at the Companies House.

The new law is different and targets non-UK resident (overseas) entities, which means bodies corporate, partnerships or other legal entities governed by the law of a country or territory outside the UK. This will include companies registered in the Channel Islands, the Isle of Man, the Cayman Islands and the British Virgin Islands. The hope is that it will make it more difficult to launder the proceeds of crime and corruption through use of UK property.

Beneficial ownership register: How it will work

Overseas entities that (at the date of commencement) either hold or intend to buy or lease any type of UK real estate must register details of their beneficial owners. A beneficial owner is defined in the same way as for the PSC rules and includes individuals, legal entities and public authorities owning, directly or indirectly, 25% or more of the shares or voting rights in the overseas entity.

The overseas entity must provide information on their registrable beneficial owners similar to that under the PSC rules, including: the beneficial owner's name; country of incorporation or formation; registered or principal office; any public register in its country of incorporation or formation on which its details are already held; and, if applicable, its registration number in that register. Where the beneficial owner is an individual, similar information must be supplied, such as name, date of birth, nationality, usual residential address, service address and the date they became a registrable beneficial owner in relation to the overseas entity.

The obligation for an overseas entity

An overseas entity is required to confirm that it has taken reasonable steps to identify its beneficial owners, and to make a statement declaring that it alternatively has:

a. identified one or more beneficial owners and has no reason to believe there are others, and that it is able to provide the required information about those identified; or

b. no reason to believe that it has any registrable beneficial owners – in which case, the entity must provide required information about its managing officers (for example, directors or company secretary); or

c. reasonable cause to believe that it has one or more registrable beneficial owners, but has been unable to identify them and therefore cannot provide all the required information. The overseas entity must in this case provide the required information about each managing officer of the entity and as much of the required information as it has been able to obtain about the beneficial owners.

The register will be held at the Companies House and is expected to be (in the main) accessible to the public for free. Once an overseas entity has registered the information, the entity will be issued a registration number, which will have to be submitted when the overseas entity wants to sell, buy or lease UK real estate. Overseas entities who try to buy or lease UK land after the law comes into force and who do not have a valid registration number will obtain beneficial, but not legal, title to the property, such that they will not be able to transfer the legal title to anyone else.

Overseas entities that already hold UK real estate will have 18 months from the commencement date of the new rules to provide beneficial ownership and other information to the Companies House. Existing owners can organize a disposal within that time if they do not want to fall within the reporting regime.

The overseas entity also will be required to provide up to date information for the register annually, or confirm that the information on the register is still accurate. In its recommendations, the Joint Committee noted that the register should be as accurate as possible at the point at which dispositions take place, i.e., in addition to the annual update. The Government is considering how to implement this requirement so it will likely be an amendment to the draft Bill prior to enactment.

It will not be necessary for a beneficial owner's details to be registered if it only holds its interest through one or more legal entities that is/are subject to disclosure requirements under different rules (e.g., the PSC regime).

Penalties for non-compliance with the regime

Penalties for non-compliance will include:

- a ban on the overseas entity selling or leasing property without first having registered details of its beneficial owners. This ban could be accompanied by a maximum of 5 years in jail for any individual officer of the overseas entity who commits this offense and/or an unlimited fine;
- up to two years in prison and/or an unlimited fine for failure to update the register;
- a fine for failure to resolve inconsistent information on the register; and
- a fine and/or imprisonment for supplying misleading, false or deceptive information.

Conclusion

Irrespective of what happens to the UK political landscape over the next 2 years, the new rules are expected to come into force in early 2021, as financial and corporate transparency is one of the issues that enjoys broad-based cross-party support in the UK Parliament.

The rules currently are only in draft form so it is possible that the final form of the regime will differ in some minor respects.

This development is the latest in a series of measures targeting non-resident owners of UK real estate. These measures assess higher rates of stamp duty land tax on non-resident corporate buyers of residential property, bringing UK real estate profits of non-resident buyers within the UK corporation tax net (as opposed to the income tax net) and extend the UK capital gains tax regime to all non-resident owners of all types of UK land.

The register represents a significant extension of the existing transparency measures and will create some major legal and compliance hurdles for non-resident entities. It is, however, a development that supports the international drive towards greater transparency and further erodes the possibilities for anonymous ownership of assets.

By Claudine Fox, Washington DC

The New Ki(D) on the Block: Business Partners May Split up via a Tax-Free "D" Reorganization

On July 26, 2019, the IRS held that the shareholders of a closely held business may split up their business, via a qualifying, tax-free divisive "D" reorganization, to resolve differences of opinion as to how to run their business. The following series of transactions was treated as a tax-free "D" reorganization under Code Sections 355 and 368(a)(1)(D). PLR 201930011.

The distributing corporation from the ruling ("Distributing") was a subchapter S corporation for US federal income tax purposes. Distributing owned and operated a business (the "Business") for five years. Distributing was closely held, with one class of common stock outstanding. Distributing was owned equally by Shareholders A, B, C, and D. Distributing further owned a general partnership interest in another partnership (the "Partnership").

Shareholders A and B disagreed with Shareholders C and D as to how the Business should be conducted going forward. Therefore, they decided to split up the Business into two separate parts. The following series of transactions was proposed.

(1) **New Corporations**. Distributing will form two corporations: Controlled 1 and Controlled 2. Both of the corporations will make an election to be treated as subchapter S corporations for US federal income tax purposes. They will both have one class of stock outstanding, which will be owned directly by Distributing.

(2) **Contribution 1**. Distributing will contribute 50% of its assets and liabilities to Controlled 1 ("Contribution 1"), including the following: (a) 50% of its Partnership interest; (b) 50% of Asset 1; (c) 100% of Asset 2, Asset 3, and Asset 4; and (d) cash in exchange for all of the stock of Controlled 1 and its assumption of liabilities.

(3) **Contribution 2**. Distributing will contribute the remaining 50% of the asset and liabilities to Controlled 2 ("Contribution 2"), including the following: (a) 50% of its Partnership interest; (b) 50% of Asset 1; (c) 100% of Asset 5, Asset 6, Asset 7, Asset 8, and Asset 9; and (d) cash in exchange for all of the stock of Controlled 2 and its assumption of liabilities.

(4) **Distribution 1**. Distributing will distribute all of Controlled 1 stock to Shareholders A and B in exchange for all of their Distributing stock.

(5) **Distribution 2**. Distributing will distribute all of Controlled 2 stock to Shareholders C and D in exchange for all of their Distributing stock.

(6) **Liquidation**. Distributing will be liquidated as part of the reorganization.

(7) **Sale of Asset**. Controlled 1 and Controlled 2 will sell Asset 1 as soon as the necessary steps required by the applicable state law are completed.

The IRS held that the two rounds of contribution and of distribution, followed by the liquidation of Distributing, is a section 368(a)(1)(D) reorganization. The IRS added that each party involved in such "D" reorganization (e.g., Distributing, Controlled 1, Controlled 2, and Shareholders A, B, C, and D) would not recognize any gain or loss from the proposed steps above.

Basis in Assets. The IRS clarified that Controlled 1's basis in each asset received from Distributing in Contribution 1 will equal the basis of such asset in the hands of Distributing immediately before Contribution 1. Similarly, Controlled 2's basis in each asset received from Distributing in Contribution 2 will equal the basis of such asset in the hands of Distributing immediately before Contribution 2.

Under sections 358(a)(1) and (b), the aggregate basis of the Controlled 1 stock received by Shareholders A and B immediately after Distribution 1 will be the same as such shareholders' aggregate basis in the Distributing stock surrendered in exchange. Similarly, the aggregate basis of the Controlled 2 stock received by Shareholders C and D immediately after Distribution 2 will be the same as such shareholders' aggregate basis in the Distributing stock surrendered in exchange.

Holding Period. The IRS provided that the holding period for each asset received by Controlled 1 in Contribution 1 and Controlled 2 in Contribution 2 will include the period during which such asset was held by Distribution, per section 1223(2).

The holding period of the Controlled 1 stock received by Shareholders A and B in Distribution 1 will include the holding period of the Distributing stock exchanged, provided that such Distributing stock is held as a capital asset on the date of Distribution 1. Similarly, the holding period of the Controlled 2 stock received by Shareholders C and D in Distribution 2 will include the holding period of the Distributing stock exchanged, provided that such Distributing stock is held as a capital asset on the date of Distribution 2.

The Business Purpose Requirement under Code Section 355

To qualify under section 355, a distribution must satisfy various requirements, one of which is to have a valid business purpose. A distribution qualifies as a section 355 transaction only if it is carried out for one or more valid, substantial business purposes. Treas. Reg. Section 1.355-2(b). The business purpose requirement makes the non-recognition treatment available only to distributions that are related to readjustments of corporate structures required by the business needs. If a business purpose can be achieved through a non-taxable transaction not involving the distribution of stock of a controlled corporation, and it is neither impractical nor unduly expensive, then the distribution will not be treated as satisfying the business purpose requirement.

A non-exclusive list of qualifying business purposes can be found in Appendix A to Rev. Proc. 96-30.

(1) **Key employee**. To provide an equity interest in either the distributing corporation or controlled corporation for existing or prospective key employees.

(2) **Stock offering**. To separate two businesses to facilitate a stock offering or access to equity capital for one of the businesses.

(3) **Borrowing**. To allow either the distributing or controlled corporation to raise a substantial amount of capital in the near future to fund operations, acquisitions, capital expenditures, or other business needs.

(4) **Cost Savings**. To achieve financing, administrative insurance, and state or other non-federal tax savings.

(5) **Fit and Focus**. To enhance the success of the corporation's businesses by enabling the taxpayer to resolve management, systemic, or other problems that arose from (or were exacerbated by) the taxpayer's operation of different businesses within a single corporation or affiliated group.

(6) **Competition**. To resolve problems with customers or suppliers who objected to the association of the distributing corporation or the controlled corporation with a business that competed with that customer or supplier.

(7) **Facilitating an Acquisition of Distributing or Controlled**. To facilitate the tax-free acquisition of either the distributing corporation or controlled corporation.

(8) **Facilitating an Acquisition by Distributing or Controlled**. To facilitate an acquisition by the distributing corporation or the controlled corporation.

(9) **Risk Reduction**. To enhance the protection of one or more businesses from the risks of another business.

The taxpayer from the ruling provided that its proposed transaction was for purposes of resolving the differences of opinion among the shareholders as to how the Business should be conducted. The IRS ruled that the split-up transaction is a qualifying, non-taxable divisive "D" reorganization under sections 355 and 368(a)(1)(D). While the IRS did not make any specific determination as to whether the business purpose test has been met, this letter ruling implies that the business purpose requirement may be met when shareholders of a closely held S corporation split up their business because they disagree with regard to how it should be conducted.

By Mary Yoo, Chicago

Canada Introduces New Stock Option Legislation Applying to Stock Options Granted on or After January 1, 2020

Employee Treatment

The Canadian government announced in its March 2019 budget that it would be introducing legislation before the summer to impose a $200,000 annual cap on the favorable tax treatment available to Canadian employees exercising employee stock options in certain situations. On June 17, 2019, the government introduced draft tax legislation that will apply to employee stock options granted on or after January 1, 2020. The proposed legislation will apply to stock options granted by corporations other than CCPCs (i.e., Canadian controlled-private corporations) that are not "start-ups, emerging or scale-up companies", as well as mutual fund trusts. The term "start-ups, emerging or scale-up companies" will be defined by regulation after a consultation period ending on September 16, 2019. Once enacted, the legislation will take effect for options granted on or after January 1, 2020.

Currently, an employee taxable in Canada is entitled to deduct for Canadian tax purposes an amount equal to one-half of the stock option benefit (the "50% deduction") arising on exercise, without limitation. To be eligible for the 50% deduction: (1) the employee must be dealing at arm's length with the employer at the time the option is granted; (2) the exercise price of the option must not be less than the fair market value of the security at the time the option is granted (i.e., it must not be "in the money"); and (3) the security must be a prescribed share (under section 6204 of the Income Tax Regulations) i.e., generally, a common share.

As a result of the proposed amendments, Canadian employees of stock options issued on or after January 1, 2020, by CCPCs or by "start-ups, emerging or scale-up companies" will still qualify for the 50% deduction without limitation provided that the conditions above are satisfied. However, employees in Canada of US corporations or other corporations not resident in Canada that are not "start-ups, emerging or scale-up companies" (or mutual fund trusts) will be subject to the new rules. Under the new rules, stock options in excess of a $200,000 per year cap described below will be "non-qualified options" and employees exercising in respect of non-qualified options will be fully taxed on the stock option benefits in the year of exercise. Other options ("qualified options") will continue to be subject to the current regime.

By way of example, under the new rules assume an employee is granted options by a non-CCPC or by a corporation that is not a start-up, emerging or scale-up company (or by a mutual trust) in 2020 to acquire 200,000 shares at price of $50 per share (being the fair market value of the share on the date the options are granted) with 25% of the options vesting in each of 2021, 2022, 2023 and 2024. In such case, only 4,000 shares ($200,000/$50) per year would be qualified options entitled to the 50% deduction in each of 2021 to 2024, inclusive. The remaining 46,000 shares that vest each year would not be eligible for the 50% deduction, and would be non-qualified options. Thus, if the employee exercised all of the options in 2024 at a when time the price of a share had increased to $70, only $320,000 (($70 - $50) x 16,000) of the stock option benefit would be entitled to the 50% deduction and would be taxed in the employee's hands at 50% of the employee's ordinary rate. The remaining $3,680,000 (($70-$50) x 184,000) of the employee stock option benefit would be included in the employee's income and would be fully taxed in the employee's hands at ordinary rates.

The proposed amendments contain an "ordering rule" to deal with situations where employees hold both qualified options and non-qualified options. Under the proposed rule, the qualified options will be deemed to have been exercised first. Options that vest in the same calendar year as qualified options previously granted will be non-qualified options if the previously granted options have "filled" the $200,000 annual cap for that year. The proposed amendments also provide that an option will be regarded as becoming vested in the year specified in an option agreement even if the option could become vested prior to the year specified in the agreement as a consequence of an event that is not reasonably foreseeable at the time of the grant. In any other case, the option will be treated as becoming vested in the first calendar year in which the option can reasonably be expected to be exercised. This may lead to uncertainty where (for example) vesting is tied to performance-based criteria.

Employer Treatment

Currently, stock option benefits that are taxable in Canada in the hands of employees generally are not deductible by the employer. For employee stock options granted in excess of the $200,000 limit, under the proposed legislation the employer will be entitled to an income tax deduction in respect of the stock option benefit included in the employee's income. Employers also will be entitled to obtain a deduction because the employer has designated the options as being non-qualified options. Employers will be required to notify employees in writing at the time of the grant of options that would otherwise be qualified options, if the options are non-qualified options either because the options exceed the $200,000 annual cap or because the employer has designated the options as being non-qualified options (in order to claim the employer deduction). The employer is also required to notify the CRA in prescribed form in the employer's tax return for the taxation year in which the options were granted. The proposed amendments appear to permit a corporate deduction only where the options are granted by the employer. Thus, where a foreign parent corporation grants options to employees of its Canadian subsidiary, the Canadian subsidiary would not be entitled to the employer deduction. The Explanatory Notes, however, suggest that this was not the Department of Finance's intention. Rather, the Explanatory Notes indicate that where a corporation grants options to employees of a non-arm's length corporation, it is the employer and not the issuer who may claim the deduction. Presumably the Department of Finance will clarify this issue before the proposed amendments are enacted.

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Corporations that are not subject to the new rules will not be permitted to opt into the new employee stock option rules.

By Brian Segal and Stephanie Dewey, Toronto

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