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INSIGHTS

INDIA BUDGET 2016-17

EXCHANGE OF INFORMATION: ISRAEL INCHES TOWARD INTERNATIONAL NORMS

U.S. TREASURY ANNOUNCES NEW U.S. MODEL INCOME TAX CONVENTION

CORPORATE MATTERS: ANATOMY OF A LIMITED LIABILITY COMPANY AGREEMENT – PART I

AND MORE

Insights Vol. 3 No. 3

TABLE OF CONTENTS

EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **India Budget 2016-2017.** On February 29, 2016, the Indian Finance Minister presented Budget 2016-17 and Finance Bill, 2016 to the Indian Parliament. Significant amendments to the tax law reflecting several B.E.P.S. recommendations and key economic policy proposals were announced. Jairaj Purandare, the Founder and Chairman of JPM Advisors Pvt. Ltd. explains the winners and losers.

- **Exchange of Information: Israel Inches Toward International Norms.** The State of Israel depends on immigration for growth in population and capital. Favorable tax rules and confidentiality rules are key pillars of the policy to promote immigration. In a world that is obsessed with B.E.P.S., Israeli policy towards confidentiality is experiencing change. Boaz Feinberg and Ofir Paz of ZAG-S&W, Tel Aviv discuss the scope of that change.

- **Treasury Announces New U.S. Model Income Tax Treaty.** On February 17, 2016, the Treasury Department released its 2016 Model Treaty. The model serves as the baseline from which the U.S. initiates treaty negotiations. Various provisions are discussed in this month's *Insights*.

  - **Introduction.** Stanley C. Ruchelman examines several provisions, pointing out various areas of super-complexity that are encountered in the 2016 Model Treaty in order to prevent double non-taxation. This is a byproduct of B.E.P.S.

  - **Special Tax Regimes.** A new provision of the 2016 Model Treaty attacks special tax regimes. Treaty benefits are denied for payments to connected persons who benefit from such provisions. Patent box regimes and regimes that allow for notional interest deductions are specifically targeted. Christine Long and Stanley C. Ruchelman explain.

  - **Limitation on Benefits Revisions.** Those who thought that the limitation on benefits ("L.O.B.") provision under the U.S.-Netherlands Income Tax Treaty was complex will find that the level of complexity in the 2016 Model Treaty has been raised several levels. Some taxpayers will be losers and others will be winners. Philip R. Hirschfeld and Galia Antebi explain how the revised provision will work.

  - **Mandatory Arbitration.** Taking a cue from the U.S.-Canada Income Tax Treaty, the 2016 Model Treaty provides for mandatory arbitration as part of the article on Mutual Agreement Procedure. I.R.S. statistics indicate that under the Canadian treaty 80% of cases were resolved by the competent authorities in lieu of risking an adverse decision through arbitration. Kenneth Lobo explains the revised provision and places it in context.

  - **B.E.P.S. and Expatriated Entities.** The 2016 Model Treaty adopts certain B.E.P.S. provisions, including those that eliminate double non-taxation through a splintered operation which divides a long-term project among several related parties and each party maintains the project for a limited time. That type of planning no longer works. Other B.E.P.S.-related revisions are missing. Sheryl Shah and Elizabeth V. Zanet explain what is out and what is in. They also address the way payments from expatriated entities are treated. It is not all bad news.

- **Tax 101: Corporate Reorganizations Part II – Types C, D, E, & F.** Rusudan Shervashidze and Andrew P. Mitchel continue their series on the basic rules that must be met for a transaction to be treated as tax-free reorganization under U.S. tax law. Part II discusses practical mergers, acquisitive D-reorganizations, recapitalizations, and changes to the identity, form, or place of organization of a single corporation.

- **Corporate Matters: Anatomy of a Limited Liability Company Agreement – Part I.** Simon H. Prisk and Nina Krauthamer begin a series on the reasons why a carefully crafted L.L.C. agreement is important in a joint venture. Commonly referred to as an operating agreement, this governance tool addresses the purpose, management, and overall operation of an L.L.C. and the obligations of members to make capital contributions.

- **F.A.T.C.A. 24/7.** This month, Galia Antebi and Philip R. Hirschfeld discuss (i) changes to F.A.T.C.A. regulations designed to ease burdens on F.F.I.'s; (ii) continued I.R.S. interest in public comments; (iii) finalization of domestic entity reporting regulations under Code § 6038D; (iv) an exemption from F.A.T.C.A. for a Swiss attorney's confidential client escrow accounts; (v) competent authority agreements that have been reached with Brazil, Colombia, and Italy; and (vi) an updated list of I.G.A. partner countries.

- **Updates & Tidbits.** Kenneth Lobo, Sheryl Shah, and Beate Erwin look at the following recent developments: (i) an A.B.A. recommendation for higher Cuban compensation for seized U.S. businesses, (ii) U.S. inversions and European State Aid investigations targeting U.S. companies, (iii) an increase in the stakes faced by Coca Cola in its transfer pricing dispute with the I.R.S., and (iv) the U.K. reaction to the Google Settlement tax payment.

We hope you enjoy this issue.

- The Editors

INDIA BUDGET 2016-17

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India

INTRODUCTION

The Indian Finance Minister presented the Union Budget for 2016-17 ("Budget 2016-17") and Finance Bill, 2016 in Parliament on February 29, 2016. Along with proposed amendments to the tax law, key economic figures (as per the annual economic survey) and policy proposals were also announced.

The proposals indicate that India is poised to experience sustainable growth, owing to favorable macro-economic factors and demographics, rising income, greater urbanization, and increasing focus on manufacturing activities. The positive domestic outlook is offset by turmoil in the global economic climate, characterized by uncertainty, low growth, and turbulent financial markets. For financial year ("F.Y.") 2016-17, the International Monetary Fund ("I.M.F.") projects 7.5% growth in India, while the estimates for global economic growth plummeted from 3.4% for 2014 to 3.1% for 2015. The negative Wholesale Price Index ("W.P.I.") of -2.8% and a reduction in the Consumer Price Index ("C.P.I.") from 5.9% in F.Y. 2014-15 to 4.95% in F.Y. 2015-16 highlight the stability of the Indian economy. Adherence to the fiscal deficit target of 3.5% is a sign of the Indian government's commitment to fiscal discipline.

Budget 2016-17 places an emphasis on infrastructure development, financial sector reforms, ease of doing business, education and skill development, and job creation.

This article focuses on key proposals of Finance Bill, 2016.

POLICY ANNOUNCEMENTS

Infrastructure and Investment

- Total outlay of I.N.R. 2.18 trillion (approximately $32.5 billion) is proposed for roads and railways.
- A bill is to be introduced regarding resolution of disputes in infrastructure-related construction contracts and Public Private Partnership ("P.P.P.") and public utility contracts. Guidelines will be issued for renegotiation of P.P.P. Concession Agreements.
- A dedicated fund is to be set up by the Life Insurance Corporation of India ("L.I.C.") to provide credit enhancement to infrastructure projects.
- A new credit rating system is to be set up for infrastructure projects.

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Fiscal Discipline

- The fiscal deficit will be set as a target range rather than a fixed number, by way of an amendment to the Fiscal Responsibility and Budget Management Act, 2003 ("F.R.B.M. Act").

Relaxation of Foreign Direct Investment ("F.D.I.") Policy

- 100% F.D.I. will be allowed in marketing of food products produced and manufactured in India under the Foreign Investment Promotion Board ("F.I.P.B.") approval route.
- Investment in insurance and pension sectors will be allowed up to 49% under the automatic route for government approval.
- 100% investment in asset reconstruction companies will be permitted under the automatic route for government approval.
- The investment limit by foreign entities in Indian financial exchanges will be increased from 5% to 15%, which is on par with domestic institutions.
- The investment limit for Foreign Portfolio Investors ("F.P.I.'s") investing in listed central public sector enterprises (other than banks) will be increased to 49%.
- F.D.I. will be allowed in additional activities beyond the 18 Non-Banking Financial Company activities specified under the automatic route for governmental approval.
- Hybrid instruments will be included among eligible F.D.I. instruments.

Financial Sector

- A comprehensive code on the resolution of bankruptcy situations of financial firms will be introduced.
- New derivative products are to be developed by the Securities and Exchange Board of India ("S.E.B.I.") in the commodity derivatives market.
- A proposed I.N.R. 2.50 billion (approximately $37.5 million) will be devoted to recapitalization of public sector banks.

Governance and Ease of Doing Business

- Amendments will be made to the Companies Act, 2013 to improve ease of doing business and to enable the registration of companies in a single day.

INCOME TAX PROPOSALS

Most direct tax proposals in Finance Bill, 2016 are effective from F.Y. 2016-17, *i.e.*, from April 1, 2016 unless otherwise specifically stated.

Tax Rates

The basic tax rates for domestic and foreign companies will remain unchanged, at

30% and 40%, respectively. Separately, for companies having turnover or gross receipts not exceeding I.N.R. 50 million (approximately $750,000) in F.Y. 2014-15, the basic rate of tax will be reduced to 29%.

Newly-established[1] domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%. Companies that exercise this option will not be eligible for deductions and reliefs that are otherwise allowable, except for the deduction for compensation paid to additional workmen employed.

"Newly-established domestic companies engaged in the business of manufacturing will have an option to pay tax at a reduced basic rate of 25%."

The basic rate of tax for individuals will remain unchanged. However, the rate of surcharge that is levied on the amount of income tax will be increased to 15% for individuals earning income in excess of I.N.R. 10 million (approximately $150,000) in any financial year.

The basic rates of tax for Minimum Alternate Tax ("M.A.T.") and Dividend Distribution Tax ("D.D.T.") will remain unchanged, at 18.5% and 15%, respectively.

Taxation of Dividend Income Exceeding I.N.R. 1 Million

Under existing domestic tax law, where a dividend is paid by an Indian company, the Indian company is required to pay 15% D.D.T. on the amount of the dividend, plus a surcharge and education cess.[2] Once these amounts are paid, the dividend is exempt from further tax in the hands of the recipient, whether resident or nonresident ("N.R.").

It is now proposed that dividends received by resident individuals and firms in excess of I.N.R. 1 million (approximately $15,000) will be taxed at 10%, on a gross basis. If implemented, this proposal will have numerous adverse consequences. Most notably, it will amount to the same income being taxed three separate times:

- Corporate tax imposed on the corporation
- D.D.T. imposed on the corporation
- Proposed tax of 10% on the shareholder

This provision also has the effect of discriminating between residents and N.R.'s. Further, it will adversely affect promoters holding shares directly and may lead to disputes over the taxability of dividends in the case of taxable non-business trusts that receive dividends exceeding I.N.R. 1 million, even if the shares of individual beneficiaries are less than I.N.R. 1 million.

Provisions Relating to N.R.'s

Equalization Levy to Tax B2B E-commerce Transactions

It is proposed that a 6% "equalization levy" will be charged on the gross amount of consideration for specified services received or receivable by an N.R. that does not have a permanent establishment ("P.E.") in India when the consideration is received from residents carrying on a business or profession in India or N.R.'s having a P.E. in India.

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1 *I.e.*, incorporated on or after March 1, 2016.

2 A cess is a type of tax levied by the Indian Tax Authorities, which must be used for a particular purpose, here education.

No levy will be charged in any of the following fact patterns:

- The N.R. providing the specified service has a P.E. in India and the specified service is connected with the P.E.
- The total consideration received/receivable by the N.R. does not exceed I.N.R. 100,000 (approximately $1,500) in any F.Y.
- The services are not provided for the purpose of carrying on a business or profession.

Income on which the equalization levy is charged will be exempt from income tax.

The payer of a consideration that is subject to the equalization levy will be required to deduct the levy from the amount payable to an N.R. If no deduction is made by the payer, a deduction for the entire consideration will be disallowed in computing the income of the payer.

Procedures for collection of the levy, interest, penalties, and prosecution are in *pari materia* with withholding tax provisions under the domestic tax law.

This provision has been introduced to extend the scope of taxation to transactions relating to the digital economy and is based on the recommendations of the O.E.C.D. committee on base erosion and profit shifting ("B.E.P.S."). At present, income from digital economy transactions is not taxable in India, in accordance with India's Double Taxation Avoidance Agreements ("D.T.A.A.'s"), since the relevant foreign entities do not maintain a P.E. in India. However, these transactions are intended to be brought under the ambit of taxation by way of introduction of the equalization levy.

"It may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is per se not a 'tax' under the domestic tax law."

However, it may be noted that the amount of equalization levy paid in India may not be available as a credit in the home country of the N.R., as this amount is *per se* not a "tax" under the domestic tax law. For U.S. companies that provide services to Indian clients from locations in the U.S., the income is domestic-source income. Consequently, even if the tax is an income tax under U.S. concepts, it cannot be used to offset U.S. income tax on the consideration received.

The proposed amendment will be effective from a date to be stipulated by the Indian government.

Tax Incentives for International Financial Services Centers ("I.F.S.C.'s")

Various incentives are proposed with regard to entities set up in an I.F.S.C. to enable the I.F.S.C.'s to become international financial hubs.

Securities Transaction Tax ("S.T.T.") will not be payable on transactions in securities undertaken on a recognized stock exchange located in an I.F.S.C. In addition, the existing exemption from Long Term Capital Gains ("L.T.C.G.'s") will be extended to transactions undertaken in foreign currency on a recognized stock exchange by an entity located in an I.F.S.C., even if no S.T.T. is paid on such transactions.

Companies located in an I.F.S.C. will be entitled to pay M.A.T. at a reduced rate of 9%, if the income of such companies is derived solely in foreign exchange.

Further, no tax will be levied on distributions of profits by a company located in an I.F.S.C. that derives income solely in foreign exchange, and such dividend income will also not be taxable in the hands of the recipient.

These are welcome measures to promote the growth of I.F.S.C.'s.

Application of M.A.T. to Foreign Companies for the Period Prior to April 1, 2015

The issue of the application of M.A.T. on foreign companies has been a matter of long-standing debate.

It has been now clarified that M.A.T. will not be applicable to foreign companies with effect from F.Y. 2000-01, if

- the foreign company is a resident of a country or specified territory with which India has a D.T.A.A. and such company does not have a P.E. in India, or
- the foreign company is a resident of a country with which India does not have a D.T.A.A. and such company is not required to seek registration under the Companies Act in India.

This clarification will be greatly appreciated by foreign companies.

Rationalization of Withholding Tax Provisions for Categories I and II Alternative Investment Funds ("A.I.F.'s")

Income of the fund that is not business income will be exempt in the hands of the fund. In addition, income received by the investor from the investment fund, other than specified income that is taxed at the fund level, will be taxable in the hands of investor in the same manner as if the investment were made directly by investor.

The person responsible for making the payment to the investor will be required to withhold tax at 10% where the payee is a tax resident. If the payee is an N.R., the rate will be specified and may change from time to time. A certificate for deduction of tax at a lower rate may also be obtained from a tax officer.

This proposed amendment will be effective from June 1, 2016.

Country-by-Country ("CbC") Reporting

It is proposed that a three-tier structure will be implemented for transfer pricing documentation and CbC reporting, in accordance with the recommendations of the O.E.C.D. committee on B.E.P.S. Specified information will be required to be reported in the prescribed formats, if the consolidated revenue of the multinational enterprise ("M.N.E.") group exceeds the specified threshold.

- CbC reporting would involve the following:
- Local file – containing material transactions of the local taxpayer
- Master file – containing standardized information relevant to all M.N.E.'s in the group
- CbC reporting – containing information about global allocation of the M.N.E. group's income and taxes along with the location of economic activity within the M.N.E. group

“Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups.”

Exemption of Income of a Foreign Company Accruing from the Storage and Sale of Crude Oil

Income accruing or arising to a foreign company from the storage of crude oil in a facility in India and the sale of the stored crude oil to any person resident in India will be exempt, provided that such storage and sale by the foreign company is made pursuant to an agreement entered into and/or approved and notified by the Indian government.

The proposed amendment will be effective retrospectively from F.Y. 2015-16.

Relaxation of the Conditions of the Special Taxation Regime for Offshore Funds

The provision dealing with certain activities that are not considered to constitute a business connection in India has been relaxed to include funds established, incorporated, or registered in a country or a specified territory that is identified by the Indian government. Also, the existing requirement preventing funds from controlling and managing any business in or from India has been diluted so that only activities carried on in India are subject to the prohibition.

Place of Effective Management (“P.O.E.M.”) and the General Anti-Avoidance Rule (“G.A.A.R.”)

Implementation of a P.O.E.M.-based residency test for foreign companies will be deferred to April 1, 2016. Under these rules, a foreign company is treated as being resident in India if its P.O.E.M. is in India; this means that key management and commercial decisions that are necessary for the conduct of its business, as a whole, are made in substance in India.

For G.A.A.R., the scheduled effective date of April 1, 2017, remains unchanged.

Exemption from the Requirement to Furnish a Permanent Account Number (“P.A.N.”)

The higher rate of withholding tax in the absence of a P.A.N. will not apply to N.R. or foreign companies for payments of interest on long-term bonds or any other payments, subject to prescribed conditions.

Tax Incentives for Start-ups

Certain incentives will be provided to eligible, certified, start-up companies to promote the growth of entrepreneurship and start-ups. A 100% deduction of profits will be available to an eligible, certified, start-up company that is

- incorporated after March 31, 2016 but before April 1, 2019, and
- engaged in the business of innovation, development, deployment, or commercialization of new products, processes, or services driven by technology or intellectual property.

The deduction will be available for any consecutive three-out-of-five F.Y.’s after the date of incorporation of the start-up.

L.T.C.G. will be exempt if it is invested after March 31, 2016 in units of a fund that is identified by the Indian government as a qualified fund. The exemption is capped at

I.N.R. 5 million (approximately $75,000). Further, exemption will be provided if the L.T.C.G. is invested in the subscription of shares of a company that qualifies as an eligible start-up, subject to certain conditions.

Taxation of Income from Patents

A new section will be introduced to tax gross royalty income, at a concessional rate of 10%, arising from a patent developed and registered in India. However, M.A.T. provisions will be applicable to such companies. This provision will apply to a person resident in India, who is the true and first inventor.

D.D.T. on Distributions Made by a Special Purpose Vehicle ("S.P.V.") to a Business Trust

D.D.T. will not be imposed on distributions made by an S.P.V. to Real Estate Investment Trusts ("R.E.I.T.'s") or Infrastructure Investment Trusts ("Inv.I.T.'s") holding prescribed shareholdings. In addition, dividends received by R.E.I.T.'s or Inv.I.T.'s and their investors will be exempt from tax. The exemption is allowed only in respect of dividends paid out of current income generated after the date of purchase of shares of the S.P.V. by a R.E.I.T. or Inv.I.T. This proposal is expected to have a positive impact on the establishment of R.E.I.T.'s and Inv.I.T.'s. These collective investment vehicles have not been widely utilized by investors since their enactment.

Amortization of Spectrum Fees

A new provision is announced to provide for amortization of the amount actually paid to acquire rights to use radio frequency spectrum for telecommunication services. The amortization will be allowed in equal installments over the license period.

Disallowance of Expenditures Incurred in Connection with Exempt Income

Currently, under the domestic tax law, no deduction is allowed for expenses incurred in connection with earning income that is exempt from tax. In the absence of a one-to-one correlation between exempt income and the expenditure specifically incurred to earn such income, tax officers generally disallow a part of the total expenses claimed as a deduction by the taxpayer based upon a formula for computing the disallowance. In certain fact patterns, the amount of the disallowance can be greater than the actual expenditure incurred. This has been a long standing topic of dispute between taxpayers and tax examiners in India.

The budget announces provisions redressing the problem. The disallowance will be computed at 1% of average monthly value of investments yielding exempt income and will be capped at the amount of the actual expenditure. Implementation rules will be announced in coming months.

Phasing out of Deductions and Incentives

Certain profit-linked deductions and exemptions, included weighted deductions, will be phased out under the budget. In addition, the highest rate of depreciation will be restricted to 40% with effect from April 1, 2017.

Tax Dispute Resolution Scheme

In order to reduce the huge backlog of pending appeal matters, a new scheme for resolution of disputes will be introduced. The scheme relates to "tax arrears" in respect of matters pending before the first level appellate authority and "specified taxes" in respect of pending matters relating to retrospective amendments, as of February 29, 2016, and provides as follows:

Tax Arrears

- If the declarant pays the entire disputed tax demand plus interest up to the date of the scrutiny order, it will be deemed that the appeal has been withdrawn, and the taxpayer will be granted immunity from penalty and prosecution, subject to exceptions in the following paragraphs.
- If the disputed tax liability exceeds I.N.R. 1 million (approximately $15,000), a 25% minimum penalty will be due in addition to tax and interest.
- In the case of pending appeals against a penalty order, a 25% minimum penalty will be due in addition to tax and interest payable.

Specified Taxes

- The taxpayer will be required to pay the amount of disputed tax and will be granted immunity from interest, penalty, and prosecution.
- The taxpayer will be required to withdraw the relevant appeals, notices, or claims filed with an authority.

The proposed dispute resolution scheme will be effective from June 1, 2016.

Income Declaration Scheme, 2016

A new scheme will be introduced to provide an opportunity for taxpayers to disclose previously undisclosed domestic income, pertaining to the period up to F.Y. 2015-16. Tax will be payable at 30% on such income along with a 7.5% surcharge and a 7.5% penalty, resulting in an effective tax rate of 45%.

The proposed amendment will be effective from June 1, 2016, and the scheme will remain open till a date that will be notified subsequently.

Various other measures are proposed with a view to rationalize and simplify the taxation system and to transition toward a non-adversarial tax regime.

INDIRECT TAX PROPOSALS

Service Tax

- The 0.5% *Krishi Kalyan* cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the *Swachh Bharat* cess of 0.5%, which was introduced from November 15, 2015.
- Service tax exemptions in respect of the following services are withdrawn:
    - Construction services in respect of monorail and metro projects, to be taxed at a basic rate of 5.6% after abatement

- Air conditioned stage carriages, to be taxed at a basic rate of 5.6% (in line with service tax on contract carriages)
- Transport by cable car, ropeway, and tramway, to be taxed at 14%[3]

- Exemptions are given to the following services:
    - Housing projects under affordable housing schemes (*i.e.*, 30m^2 in four metropolitan areas and 60m^2 in other areas) are exempt as of March 1, 2016.
    - Services rendered by Pension Fund Regulatory and Development Authority/Employees Provident Fund Organization/Insurance Regulatory and Development Authority of India and S.E.B.I. are exempt as of April 1, 2016.[4]
    - Government-sponsored cold chain, biotechnology, and vocational training and cultural projects are exempt as of April 1, 2016.
- A single premium insurance policy will attract service tax at 1.4%, rather than the existing 3.5% rate, from April 1, 2016.
- Service tax is levied on Indian shipping lines along with the full input tax credit ("I.T.C.") available, so as to ensure parity with foreign shipping lines.
- Service tax is levied on a receipt basis and payment of service tax is made on a quarterly basis for One Person Companies ("O.P.C.'s") and Hindu Undivided Families ("H.U.F.'s").
- The C.E.N.V.A.T. credit rules have been amended to give an option to banks and financial institutions to either reverse 50% of I.T.C. or reverse only part of the credit in proportion to exempt service turnover *vis a vis* total turnover.
- A clarification had been made that the allocation of radio frequency spectrum by the Indian government will be a taxable service and not a sale of intangible goods.
- Further clarifications include mutual exclusivity of application of service tax and excise duty on one taxable event.
- Interest rates and abatements have been rationalized in line with those applicable to customs duty and excise duty payments, except when the taxpayer has collected and not paid the service tax, in which case the rate of interest is increased to 24% per annum.
- The limit for prosecution for wrongful withholding of service tax has been increased to I.N.R. 20 million (approximately $300,000), from I.N.R. 10 million (approximately $150,000) under prior law.
- The limitation period for under-collection or underpayment of service tax has been extended from 18 months to 30 months when not attributable to fraud, collusion, or misrepresentation.

"The 0.5% Krishi Kalyan cess has been introduced with effect from June 1, 2016 on all taxable services. Thus, the effective tax rate on services will be 15% considering the basic rate of service tax as well as the Swachh Bharat cess of 0.5%."

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3 This will increase costs for tourists and hence may be a retrograde step, in so far as promoting India as a tourism destination is concerned.

4 Previously only services rendered by the R.B.I. were exempt.

Excise Duty

- An infrastructure cess in the range of 1% to 4% will be levied on all motor vehicles, depending on the length of the motor vehicle, engine capacity, etc.
- The clean environment cess will be increased from I.N.R. 200 (approximately $3) per ton to I.N.R. 400 (approximately $6) per ton.

SUMMARY

Budget 2016-17 demonstrates the government's intent to promote balanced, long-term growth in India through fiscal discipline, infrastructure development, job creation, and tax and financial sector reforms. In particular, the focus on infrastructure projects has been praised by IMF chief Christine Lagarde.[5] Although Budget 2016-17 does not contain broad provisions aimed at attracting large multinational enterprises, it offers a number of more modest proposals, such as tax incentives to encourage investment through R.E.I.T.'s and Inv.I.T.'s, easing of restrictions on foreign direct investment, and benefits for start-ups and manufacturing businesses, which will strengthen the private sector and position India for sustainable, high growth rates on par with major global economies such as the U.S. and China.

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[5] "India's Fiscal Stance Sensible: IMF's Christine Lagarde," NDTV, March 13, 2016, where Ms. Lagarde is quoted as saying:

> We consider that the fiscal stance adopted by India is exactly appropriate and a very sensible objective that has been set. It's just the right one that has been set under the given circumstances.

EXCHANGE OF INFORMATION: ISRAEL INCHES TOWARD INTERNATIONAL NORMS

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INTRODUCTION

The State of Israel has always invested a large amount of effort to attract people from around the world to immigrate to Israel and to invest their funds in Israel.

As part of these efforts, Section 14 of the Israeli Income Tax Ordinance stipulates that when a person becomes a new Israeli resident, Israel grants the individual a ten-year exemption from disclosing to the Israeli tax authorities any information regarding non-Israeli assets, sources of income, and capital gains. This tax holiday also applies to senior returning residents who resume Israeli residency after residing overseas for at least ten years.

Some global tax policy officials claim that Israel has blindly accepted the source of funds that were invested in Israel by new immigrants and that it disregarded the possibility that the investments were made with the proceeds of tax evasion in other countries. For this reason, it is claimed that Israel has not been eager to disclose information regarding these funds and assets to other states.

PERSPECTIVE

The lack of willingness to disclose fiscal information between states has been a standard practice among nations, as evidenced in early multilateral conventions. One of the first conventions to deal with legal assistance between countries was the European Convention on Mutual Assistance in Criminal Matters 1959 (the "Strasbourg Convention").[1] The Strasbourg Convention specifically stipulated in Article 2 that any legal assistance may be refused in regard to fiscal offences.

Israel has adopted and ratified the Strasbourg Convention. However, in parallel to this convention, Israel, like many other states, has signed numerous double taxation treaties that call for exchange of information ("E.O.I.") regarding tax matters. In most double taxation treaties, the E.O.I. clause allows each Member State the sovereignty to decide whether or not it wishes to disclose information. Israel generally has preferred to maintain its sovereignty rather than willingly promote E.O.I. regarding assets and income located in Israel.

RECENT DEVELOPMENTS

Recently, Israel has reversed its prior position and has moved to establish an active E.O.I. policy. This is partly due to Israel's desire to obtain information regarding

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[1] European Convention on Mutual Assistance in Criminal Matters, CETS No.030, Strasbourg, April 20, 1959.

financial activities of Israeli residents abroad and partly due to the worldwide trend toward breaking all secrecy barriers between tax authorities and financial institutions. As a result, effective January 2016, Israel has instituted new laws that will enable it to join international conventions and treaties relating to the disclosure and exchange of information regarding income and assets in Israel. Consequently, Israel will provide financial information to other foreign tax authorities. In turn, Israel will receive financial information relating to its residents.

The new laws enable Israel to join the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "M.L.A.T. Convention").[2] As we will show, joining the O.E.C.D. Convention does not necessarily mean that Israel will in fact abandon its historical position of preferring sovereignty over disclosure.

Israel Joins the M.L.A.T. Convention

As mentioned above, on November 24, 2015, Israel joined the M.L.A.T. Convention, making it the 91st jurisdiction to join.[3]

The M.L.A.T. Convention obligates the Member States to exchange information with each other concerning income and assets of residents of the Member States. The information can be used by the receiving state only for income tax purposes. Information is made available on a reciprocal basis between each of two states under existing Tax Information Exchange Agreements.

The M.L.A.T. Convention applies to a wide range of taxes, including taxes on income; capital gains; net wealth; compulsory social security; estates, inheritances, or gifts; immovable property; and consumption, such as value added tax ("V.A.T."), or sales; etc.[4]

The Israeli State Revenue Administration in the Ministry of Finance has stated that Israel will enforce the M.L.A.T. Convention on direct taxes only, not including social security payments.[5] This means that the Israeli law regarding E.O.I. will not be imposed on indirect taxes, especially V.A.T. Another interesting question is with regard to real estate tax. Israel may claim, that real estate tax is not covered by the M.L.A.T. Convention. This means that Israel may decide not to transfer information regarding the purchase and sale of real estate in Israel. Furthermore, Israel will not enforce the M.L.A.T. Convention's provisions on assistance in tax examinations abroad or on tax collection and service of documents, a decision which will not be addressed in this article.

Under the M.L.A.T. Convention there are five methods of exchanging information: E.O.I. on request, automatic exchange of information ("A.E.O.I."), spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad. Each Mem

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2 O.E.C.D. and Council of Europe, *Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol*, (Paris: O.E.C.D. Publishing, 2011), last modified February 2016 (the "*O.E.C.D. Convention*").

3 O.E.C.D., "Israel Joins International Efforts to Boost Transparency and End Tax Evasion," news release, Nov. 24, 2015; Ministry of Finance, "Israel Signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters," news release, Nov. 25, 2015.

4 *O.E.C.D. Convention*, art. 2.

5 "Israel Signed the Multilateral Convention."

ber State can decide at its sole discretion whether or not to transfer information to other Member States by using one or more of these methods.

E.O.I. on Request

Upon the request of a Member State (the "Applicant State"), the Member State receiving the request (the "Requested State") must provide the Applicant State with any relevant information that concerns particular taxpayers or transactions. In order to comply with the request for information, the Requested State must provide information available in its tax files. It must also take all relevant measures to provide the Applicant State with the information requested.[6]

"Under the M.L.A.T. Convention there are five methods of exchanging information:

E.O.I. on request, A.E.O.I., spontaneous E.O.I., simultaneous tax examinations, and tax examinations abroad."

A.E.O.I.

The M.L.A.T. Convention does not specify the way to conduct A.E.O.I., and in this respect, the O.E.C.D. published the Standard for Automatic Exchange of Financial Account Information in Tax Matters (the "Standard") on July 21, 2014.[7]

The Standard calls for Member States to obtain information from domestic financial institutions and automatically exchange that information with other Member States on an annual basis. The Standard also determines the type of financial information to be reported and exchanged, the different types of accounts and taxpayers covered, and the common due diligence procedures to be followed by domestic financial institutions.

According to the Standard, financial institutions (*e.g.*, banks and insurance companies) will determine a process for identifying account owners that are residents of foreign countries. The financial institutions will then collect information with respect to such account holders and transfer that information to the relevant tax authorities in the other Member State. This information will include balances and financial revenues of foreign account holders.[8]

Given the importance of implementing A.E.O.I., competent authorities from over 79 jurisdictions have signed the Common Reporting Standard Multilateral Competent Authority Agreement (the "C.R.S. M.C.A.A."), which implements the Standard and specifies the details of what information will be exchanged and when. While the C.R.S. M.C.A.A. is multilateral, the actual A.E.O.I. will be implemented bilaterally.[9]

Israel has yet to join the C.R.S. M.C.A.A. However, on October 27, 2014, the Israeli Ministry of Finance notified the O.E.C.D. that it will adopt the procedure for the automatic exchange of financial account information for tax purposes (referred to as the "Common Reporting Standard" or the "C.R.S.") by the end of 2018. The procedure will be implemented via an agreement between the relevant authorities in countries complying with the procedure.[10]

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6 *O.E.C.D. Convention*, art. 5.

7 *Id.*, art. 6; O.E.C.D., *Standard for Automatic Exchange of Financial Account Information in Tax Matters*, (Paris: O.E.C.D. Publishing, July 21, 2014) ("*The Standard*").

8 *The Standard*.

9 *O.E.C.D. Convention*; O.E.C.D., "The CRS Multilateral Competent Authority Agreement (MCAA),"

10 Ministry of Finance, "Israel to Adopt OECD Procedure for the Automatic Exchange of Financial Account Information," news release, Oct. 27, 2015.

Spontaneous E.O.I.

A party can spontaneously forward information to another party in the following circumstances:[11]

- A party concludes that there may be a loss of tax in the other party jurisdiction.
- A taxpayer obtains a reduction or exemption from tax in a party jurisdiction, which may result in an increase in tax or liability to tax in the other party jurisdiction.
- Business dealings between two taxpayers from different party jurisdictions are conducted through one or more countries in a way that may result in tax savings in one of the party jurisdictions, or in both.
- A party concludes that tax savings may result from artificial transfers of profits within a group of enterprises.
- Information forwarded to a party by the other party may be relevant in assessing the tax liability in the latter party jurisdiction.

Simultaneous Tax Examinations

Two or more parties shall consult with each other and determine cases and procedures for simultaneous tax examinations. During these examinations, two or more parties are each conducting domestic investigations into the tax affairs of a taxpayer or taxpayers in which they have common or related interest. The purpose of these examinations is that each state will exchange any relevant information it obtains during the examinations.[12]

Tax Examinations Abroad

The competent authority of the Applicant State can request to be present in tax examinations conducted by the competent authority of the Requested State. The Requested State can refuse to include the Applicant State in its examination, and even if it decides to allow the request, all decisions with respect to the conduct of the tax examination shall only be made by the Requested State.[13]

Israel Amends Tax Laws Regarding E.O.I. with Certain Reservations

On November 19, 2015, a week before joining the M.L.A.T. Convention, the Israeli parliament, the Knesset, approved a bill to increase enforcement of the M.L.A.T. Convention against tax evaders (the "Bill").[14] As of January 1, 2016, the Bill enables the director of Israeli Tax Authority (the "I.T.A.") to transfer information to a foreign country according to an international treaty for enforcement under the tax laws of that country.[15]

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11 *O.E.C.D. Convention*, art. 7.

12 *Id.*, art. 8.

13 *Id.*, art. 9.

14 The Law of Amending the Income Tax Ordinance (No. 207) - 2015.

15 Ministry of Finance, "The State of Israel Increases Enforcement Ability Against Tax Evaders," news release, Nov. 22, 2015.

The main goal of the Bill was to enable Israel to join the M.L.A.T. Convention. However, the Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A. (which may decide whether or not to transfer information) over the promotion of E.O.I. with other Member States.

"The Bill stipulates additional conditions that allow Israel to disregard provisions of the M.L.A.T. Convention. These additional conditions give precedence to the sovereignty of the I.T.A."

According to the Bill, the director of the I.T.A. (the "Director") may transfer information to a "Foreign Tax Authority" according to an international agreement, subject to the following conditions:

1. If the information is transferred at the initiative of the Director, it should be verified that the requested information is needed for the enforcement of the domestic tax law of the foreign Member State.[16]

2. If the information is transferred at the request of the Foreign Tax Authority, the Director should be convinced that the foreign requesting country requires the requested information in order to enforce its domestic tax law.[17]

3. The I.T.A. is allowed to use the requested information in order to enforce its domestic tax law.[18]

4. The foreign country is committed to the confidentiality and safekeeping of the requested information, as determined by an international agreement.

5. The Foreign Tax Authority uses the information solely for the purpose of enforcement of its domestic tax law.

6. The Foreign Tax Authority will transfer the information to other institutions in the foreign country solely for the purpose of enforcing its domestic tax law.

7. The Foreign Tax Authority will not transfer the information to other countries.[19]

8. The I.T.A. is allowed (under current Israeli tax law) to decide to withhold information from a country that does not keep up with international standards of E.O.I.

9. The I.T.A. will notify an Israeli resident, in the case of a request for information, at least 14 days before transferring the information, unless the requesting country has asked for secrecy.

10. No information will be transferred to a Foreign Tax Authority according to an international agreement if such transfer of information could harm Israel's national security, public safety, pending investigations, public policy, or any other matters that are vital to the State of Israel.[20]

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16 It remains to be seen how Israel will interpret this provision.

17 This provision may also be widely interpreted by Israel and may result in the refusal of an information disclosure to another country.

18 "Tax law" is defined as a law that deals with the imposition of tax or with a mandatory payment that it is the responsibility of the Finance Minister to execute.

19 It is interesting to see that sections 5, 6, and 7 only apply to Foreign Tax Authorities and the I.T.A. is not subject to these provisions at all.

20 This provision may also be widely interpreted and may lead to the refusal to transfer information to other countries.

CONCLUSION

Today, even after Israel has amended its domestic law and joined the M.L.A.T. Convention, Israel's intention seems to remain the same – to obtain information with respect to its residents but not to allow for disclosure of any information to other countries where such disclosure fails to meet protective provisions under Israeli domestic law. It seems that both the new law and the provisions of the M.L.A.T. Convention do not damage the sovereignty of Israel to deny any disclosure of information.

There is no question that as long as Israel does not amend the provisions of the tax holiday given to new immigrants and senior returning residents, these individuals will be allowed to deny the I.T.A. any information regarding their foreign assets and income, and Israel will thus be unable to disclose information it does not possess.

The one exception that may have a crucial effect on the balance between sovereignty and disclosure relating to Israeli-based assets and income is the A.E.O.I. procedure, under which a Member State truly loses its ability to decide what information is disclosed to other Foreign Tax Authorities. Israel has not established a plan to implement A.E.O.I. procedures and so far has not changed its laws in this respect. According to the current Israeli law, the I.T.A. is not entitled to receive any kind of information from Israeli banks and such information can only be obtained from individual taxpayers or by a court order in connection with an on-going criminal investigation. However, it is expected that Israel will adopt A.E.O.I. procedures by the end of 2018.

Although A.E.O.I. has yet to be implemented in Israeli law, this procedure has definitely changed the way Israeli banks operate – and did so long before Israel even joined the M.L.A.T. Convention. Today, all domestic Israeli banks require that information regarding the tax residency of the account owner must be provided at the time of account opening. In addition, each account owner must sign a waiver in order to protect the bank in the event it discloses information relating to the account to the I.T.A. or to any Foreign Tax Authority.

The interesting question remains whether Israel will truly agree to relinquish its sovereignty and its historical objective of promoting immigration from around the world and allowing immigrants to bring funds with them under assurance of confidentiality.

U.S. TREASURY ANNOUNCES NEW U.S. MODEL INCOME TAX CONVENTION

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Tags
B.E.P.S.
Double Non-taxation
Expatriated Entity
Limitation on Benefits
Mandatory Arbitration
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

On February 17, 2016, the Treasury Department released a revised U.S. Model Income Tax Convention (the "2016 Model Treaty") – the baseline from which the U.S. initiates treaty negotiations.

Many of the revised provisions reflect current negotiating positions developed in actual tax treaty negotiation sessions, and on the whole, the 2016 Model Treaty should be seen as a natural progression, as taxpayers and treaty partner countries have also adapted to existing treaties. Other provisions are new and are designed to limit double non-taxation in addition to double taxation, reflecting the global attack on cross-border tax planning led by the O.E.C.D.

While a prudent planner will wish to review and compare the entire 2016 Model Treaty with its predecessor, several notable provisions are outlined below:

- The 2016 Model Treaty contains provisions designed to attack special tax regimes that provide attractive tax results for highly movable income such as interest, royalties, and guarantee fees. These regimes were created to eliminate the need for back-to-back payments after anti-conduit rules were adopted by the U.S. and other countries.

- The new Article 28 (Subsequent Changes in Law) is a provision that calls for notification and consultation with a view to amending a treaty when changes in the domestic law of a treaty partner draw into question the treaty's original balance of negotiated benefits and the need for the treaty to reduce double taxation. While the addition may be interpreted as a bold move in support of the O.E.C.D.'s B.E.P.S. initiative, it is unlikely to produce significant results, as long as the treaty partner's tax rate does not dip below 12.5%. The U.S. has income tax treaties in effect with Ireland and Cyprus, where the headline rate for each is 12.5%. It also has a treaty with Malta where the tax rate is 5% after a refund of corporate tax that is triggered by a dividend payment. The U.S. has not indicated that it would to initiate action against the U.K., where the headline rate of corporate tax is scheduled to be reduced to 17% in 2020. Comparatively, the U.S. corporate tax rate can be as high as 35% at the Federal level and around 40% when most state taxes are taken into account. The tax on distributed profits in the U.S. will add another 30% on the after-tax earnings that are distributed – about 12%, if the combined Federal and state rate is 40%.

- The 2016 Model Treaty adopts a series of highly technical provisions designed to tighten the tests under Article 22 (Limitation on Benefits) in an effort to curb cross-border tax planning that circumvents the Limitation on Benefits article in existing treaties. These provisions may be harmful to sophisticated multinational businesses. The provisions also contain an expansion of the derivative benefits provision, which applies principally to dividends when the treaty resident is owned by an individual who would be an equivalent beneficiary but for the lower withholding tax rates or exemption for intercompany direct investment dividends. This is a beneficial provision. Whether the revisions are beneficial or harmful for taxpayers, added complexity is evident in Article 22, as the various tests for qualifying taxpayers or income streams have become multifaceted.

- The 2016 Model Treaty would reduce the benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by U.S. companies that are "expatriated entities." An expatriated entity is an entity with a foreign charter, but because it or a predecessor in interest was at one time a U.S. corporation, it continues to be treated as a U.S. corporation when certain conditions are met regarding the composition of the shareholder group. For a period of ten years, treaty benefits are denied to payments by expatriated entities when the recipient is "connected" with the expatriated entity. Payments made to unconnected persons benefit from the treaty. While U.S. tax law defining an inversion may change from time to time, the definition under the 2016 Model Treaty relies upon U.S. law applicable on the date of signature of an income tax treaty. Subsequent modifications are to be ignored.
- The 2016 Model Treaty expands Article 25 (Mutual Agreement Procedure) to provide for mandatory binding arbitration. In doing so, it follows four treaties that have been submitted and await the advice and consent of the Senate. These treaties have been blocked at the level of the Senate Foreign Relations Committee for several years.
- The overall B.E.P.S. initiative policy of preventing double non-taxation is elevated to a principal purpose of the 2016 Model Treaty. However, not all of the recommended permanent establishment provisions have been adopted. In that regard, a speaker at a conference once commented on the O.E.C.D. obsession with double non-taxation in the following way: It is better that 100 taxpayers incur double taxation than that one aggressive taxpayer pays too little.[1]

This month, *Insights* explores these provisions of the 2016 Model Treaty in the articles that follow.

[1] Benjamin Franklin, letter to Benjamin Vaughan, March 14, 1785, in *The Writings of Benjamin Franklin, Volume 9*, ed. Albert H. Smyth, (1906), p. 293. Mr. Franklin was echoing Voltaire.

2016 MODEL TREATY – SPECIAL TAX REGIME PROVISIONS

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Tags
Double Non-taxation
Notional Interest Deduction
Special Tax Regimes
Tax Treaties
U.S. Model Income Tax Treaty

The U.S. Treasury Department issued a revised U.S. Model Income Tax Convention on February 17, 2016 ("2016 Model Treaty") that, among other things, implements new provisions to address special tax regime issues and prevent situations of double non-taxation. A special tax regime provides preferential tax treatment (usually in the form of a low or zero tax rate) for payments of interest, royalties, or other similar, highly-mobile income to taxpayers that reside in the relevant jurisdiction. The 2016 Model Treaty enumerates the circumstances in which a reduction in the U.S. statutory withholding rates on deductible payments to a treaty resident will be denied because the resident benefits from a particular special tax regime.

The Treasury Department has targeted the provision on special tax regimes to prevent erosion of the U.S. tax base without an offsetting tax in the country of residence. This is viewed to be unfair to existing U.S. corporations and incentive for U.S. businesses to undergo inversions to foreign corporations. The special tax regime provisions also reflect the concerns of the O.E.C.D. in connection with double non-taxation, a target of the B.E.P.S. initiative.[1]

The previous Model Treaty, which was issued in 2006 ("2006 Model Treaty"), did not have express provisions dealing with the problems of double tax avoidance caused by special tax regimes. In May 2015, the Treasury Department invited the public to comment on a draft of the revised Model Treaty (the "2015 Draft"), which added new special tax regime provisions that were not in the 2006 Model Treaty. Overall, the comments on the 2015 Draft conveyed that the term "special tax regime" was too expansive, the provisions were too ambiguous as to when treaty benefits and reductions of withholding taxes would be denied, and public notification should be required before implementing provisions of a particular special tax regime so that taxpayers may properly apply the treaty.[2] The 2016 Model Treaty addresses these comments and more carefully defines the application of special tax regime provisions.

SPECIAL TAX REGIME PROVISIONS

The 2016 Model Treaty's special tax regime provisions only apply to particular payments of interest, royalties, or guarantee fees from a related or connected party to a resident of a treaty country that benefits from a special tax regime. The special tax regime provisions are defined in Article 3 (General Definitions) and apply to Article 11 (Interest), Article 12 (Royalties), and Article 21 (Other Income) of the 2016 Model Treaty.

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1 U.S. Department of the Treasury, *Preamble to 2016 U.S. Model Income Tax Convention*, (Feb. 17, 2016), p. 2.

2 *Id.*

The term “special tax regime” is a new addition to the Model Treaty. A special tax regime means any statute, regulation, or administrative practice related to a tax covered by the treaty that meets all of the following conditions:[3]

- It results in one or more of the following benefits for a resident of the country:
    - Preferential taxation for interest, royalties, guarantee fees, or any combination of those items, as compared to income from sales of goods or services
    - A permanent reduction in the tax base with respect to the above categories of income by allowing
        - an exclusion from gross receipts,
        - a deduction without corresponding payment or obligation,
        - a deduction for dividends paid or accrued, or
        - taxation that is inconsistent with the principles of the business profits and permanent establishment articles in that a preferential tax rate or permanent reduction in the tax base is available to companies that do not engage in an active business in the resident treaty country.[4]
    - Other similar tax benefit applied to substantially all of a company’s income or substantially all of a company’s foreign source income for companies that do not engage in the active conduct of a trade or business in the country of residence
- For patent or innovation box regimes, the preferential rate of taxation or permanent reduction in the tax base does not condition the tax benefits on research and development activities within the state of residence.
- The special tax regime is generally expected to result in a rate of taxation that is less than lower of the following to rates:
    - 15%
    - 60% of the statutory rate of corporation tax that is generally applied

The 2016 Model Treaty’s special tax regime provisions expressly do not apply to pension funds, charitable organizations, or collective investment vehicles such as U.S. regulated investment companies and U.S. real estate investment trusts that are designed to achieve a single level of current tax at either the entity level or shareholder level.[5]

The 2016 Model Treaty requires that a written public notification be issued by a country that implements a special tax regime provision. The country must first consult with, then notify the other treaty country of its intention to implement such

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3 *Id.*; U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016), art. 3(1)(l).

4 *2016 Model Treaty*, art. 3(1)(l)(i).

5 *Id.*, art. 3(1)(l)(iv).

provision through a diplomatic note before issuing the public notice. Such provision cannot be treated as a special tax regime until 30 days after the public notification is issued.[6] The public notification requirement was added in response to comments on the 2015 Draft.

EFFECT OF THE SPECIAL TAX REGIME PROVISIONS

Articles 11, 12, and 21 pertaining to interest, royalties, or guarantee fees, respectively, limit treaty benefits when a special tax regime applies to the recipient of income. Thus, the 2016 Model Treaty provides that:

> Interest, royalties, or guarantee fees arising in a treaty country and beneficially owned by a resident of the other treaty country that is a connected person with respect to the payor of such interest, dividend, or guarantee fee, may be taxed in the first-mentioned country in accordance with domestic law if such resident benefits from a special tax regime with respect to such income.

"Special tax regime provisions will only apply when the payee is a 'connected person' with respect to the payor of the income of interest, royalties, or guarantee fees."

These special tax regime provisions will only apply when the payee is a "connected person" with respect to the payor of the income of interest, royalties, or guarantee fees. The term "connected person" is used instead of "related to the payor" (found in the 2015 Draft) in response to concerns about the special tax regime provisions being too expansive. The term "connected person" is defined as follows:

> [T]wo persons shall be 'connected persons' if one owns, directly or indirectly, at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 percent of the beneficial interest (or, in the case of a company, at least 50 percent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.[7]

EXCEPTIONS TO THE PROVISIONS

Notional Interest Deductions

Tax regimes that provide a notional interest deduction with respect to equity are not treated as special tax regimes. However, Article 11, which pertains to interest income, allows a treaty country to tax interest when the interest is beneficially owned by a connected person and the connected person benefits from a notional interest deduction based on equity. This change represents a more focused approach to addressing the policy concern that interest income that benefits from a notional interest regime is often subject to little or no tax because (i) at the level of the lender a notional interest deduction applies in the country of residence on equity,

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[6] *2016 Model Treaty*, art. 3.

[7] *Id.*, art. 3(1)(m).

and (ii) the parent of the investor benefits from a participation exemption with respect to dividends.[8]

Moreover, use of notional interest regimes has been a favorite way for certain planners to circumvent the anti-conduit financing rules of U.S. tax law.[9] Those rules attack back-to-back financing arrangements that are designed to reduce U.S. tax. Many income streams are caught by the anti-conduit rules, including interest-in/interest-out transactions, royalties-in/royalties-out transactions, and interest-in/fixed-dividends-on-preferred-stock-out transactions all looked at from the point of view of the entity receiving payments from the U.S. However, interest-in/ordinary-common-stock-dividends-out transactions are not among the listed transactions that are caught, presumably because common stock dividends paid by the recipient of U.S.-source interest income ordinarily is not viewed as abusive. However, when the dividend-out leg is accompanied by a notional interest deduction on equity capital, the tax base in the country where the recipient of U.S.-source interest is resident has been reduced in a way that violates the spirit of the anti-conduit rules.

Exempt and Fiscally Transparent Entities

The special tax regime provisions do not apply to pension funds, charitable organizations, collective investment vehicles that are tax transparent, or other entities that are tax transparent. An entity is not tax transparent if tax is deferred for more than one year.

CONCLUSION

The new provisions implemented in the 2016 Model Treaty combat the problem of double non-taxation by denying treaty benefits for payments of interest, royalties, and certain guarantee fees between connected parties if the beneficial owner of the payment benefits from a special tax regime with respect to the payment.

8 *Preamble to the 2016 Model Treaty*, p. 3.

9 Treas. Reg. §1.881-3.

2016 MODEL TREATY – L.O.B. REVISIONS

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Tags
Limitation on Benefits
Tax Treaties
U.S. Model Income Tax Treaty
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IN GENERAL

While the U.S. Senate has not ratified a treaty since 2010, the Treasury Department released a revised U.S. Model Income Tax Convention on February 17, 2016 (the "2016 Model Treaty").[1] The 2016 Model Treaty is the baseline text used by the Treasury Department when negotiating tax treaties with other countries. The U.S. Model Income Tax Convention was last updated in 2006 (the "2006 Model Treaty").

The 2016 Model Treaty was not published with a technical explanation. However, the preamble, which accompanied the February release, provides that the Treasury Department plans to publish a technical explanation later this spring.

U.S. tax treaty negotiation policy is aimed at eliminating double taxation without creating opportunities for "treaty shopping." Treaty shopping arises when a person, or group of persons, who is not resident in the treaty country channels investments into the U.S. through a company that is resident in a treaty partner country but has no "real" nexus to that country. To prevent treaty shopping, the U.S. includes a limitation on benefits ("L.O.B.") provision in its income tax treaties. The L.O.B. provision provides that a resident of a foreign country cannot enjoy benefits under a treaty unless that resident is a "qualified person" or is otherwise entitled to claim benefits.

A draft version of the 2016 Model Treaty was released on May 20, 2015 (the "2015 Draft") for public comment. The 2015 Draft proposed changes to Article 22 (Limitation on Benefits) of the 2006 Model Treaty, and comments are reflected in the 2016 Model Treaty. In the 2016 Model Treaty, two new methods for satisfying the L.O.B. provision were added: a "derivative benefits" test and a "headquarters company" test. Additionally, a number of preexisting tests, from the 2006 Model Treaty, have been tightened to prevent abuse by third-country residence.

THE 2006 MODEL TREATY

Under the 2006 Model Treaty, there are four main categories under which a person (other than an individual, a non-for-profit organization, or a governmental body of one of the treaty countries) could qualify for treaty benefits. Generally, these categories include the following:

- A publicly traded company[2] – In order to meet this requirement, the company's principal class of stock must be traded regularly on a recognized exchange.

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[1] U.S. Department of the Treasury, *U.S. Model Income Tax Convention*, (Feb. 17, 2016).

[2] *Id.*, art. 22(2)(c)(i).

- A company that is a subsidiary or an affiliate of a publicly traded company[3] – In order to meet this requirement, 50% or more of the vote and value of the company's stock must be owned by five or fewer publicly traded companies that are qualified persons. Indirect ownership was allowed only through companies that are residents of either contracting state.

- A pension fund in which more than 50% of the beneficiaries, members, or participants are individuals resident in either the foreign country or the U.S.[4]

- A company that meets the "ownership/base erosion" test[5] – The ownership prong of this test requires that persons who are otherwise qualified persons under the treaty must own 50% or more of the vote and value of that company for at least half the year. The base erosion prong requires that disqualifying payments representing 50% or more of the company's gross income must not be made. Payments are disqualifying when they are (i) made to impermissible payees (*i.e.*, generally, payees other than individuals, governmental entities, tax-exempt entities, pension funds, and public companies that are residents of one of the contracting states and eligible for treaty benefits), (ii) tax deductible in the country of residence, and (iii) not arm's length payments made in the ordinary course of the company's business for services rendered or for the purchase of tangible property. Typically, payments that are caught in this base erosion prong are interest payments, royalty paymens, and fees for management services.

The 2006 Model Treaty also permits treaty benefits to be claimed by companies that are not qualified persons, but only for specific streams of income. Companies covered by this provision include

- a company that is actively engaged in a trade or business in its country of residence (generally, other than the business of making or managing investments for the resident's own account), but only with respect to income that is "derived in connection with" that trade or business or is incidental to that business;[6] and

- a company that is granted discretionary relief by the competent authority of the source country, based on a determination that the "establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under this Convention."[7]

REVISIONS MADE IN THE 2016 MODEL TREATY

Public Subsidiary Exception Modified

The 2016 Model Treaty modifies the regarding a subsidiary of a publicly traded company (i) to include a base erosion test and (ii) to allow for indirect ownership

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3 *Id.*, art. 22(2)(c)(ii).

4 *Id.*, art. 22(2)(d).

5 *Id.*, art. 22(2)(e).

6 *Id.*, art. 22(3).

7 *Id.*, art. 22(4).

through a qualifying intermediate owner who is resident in a third state, but only if that state has a tax treaty with the country in which the income arises that includes provisions addressing special tax regimes ("S.T.R.'s") and notional interest deductions ("N.I.D.") similar to those in the 2016 Model Treaty (the "New Intermediate Ownership Rules"). Currently, no treaty includes such provisions.

The base erosion test in the 2016 Model Treaty is not applicable when the income for which treaty benefits are claimed is dividend income. Generally, a base erosion test provides that the company seeking treaty benefits may not, directly or indirectly, pay or accrue 50% or more of its gross income to impermissible payees in the form of payments that are deductible for tax purposes in the country of residence, not counting certain payments made in the ordinary course of business. The base erosion test in the 2016 Model Treaty expands the list of "bad payments" to include a payment made to a connected person that benefits from (i) an S.T.R. provision with respect to the payment or (ii) an N.I.D. provision in the residence state when the item of income is an interest payment. Additionally, the 2016 Model Treaty provides that, if the company seeking treaty benefits is a member with any other company in a tax consolidation, fiscal unity, or similar regime that requires members to share profits or losses or it shares losses with other companies pursuant to a group relief or other loss-sharing regime, the other company or companies must also meet the base erosion test. In other words, both the tested group of companies and the company receiving income must meet the base erosion standard.

"The base erosion test in the 2016 Model Treaty expands the list of 'bad payments' to include a payment made to a connected person."

The list of permissible payees under the base erosion prong of the 2016 Model Treaty is the same one that appears in the standalone ownership/base erosion test of the 2006 Model Treaty; it includes individuals, governmental entities, public companies, tax-exempt entities, and pension funds resident in one of the contracting states. Arm's length payments made in the ordinary course of business for services or tangible property and, in the case of a tested group, intra-group transactions are not taken into account when making the determination.

Active Trade or Business Test Modified

The active trade or business test in the 2016 Model Treaty requires a factual connection between an active trade or business in the residence country and the item of income for which benefits are sought. Specifically, the income benefiting from the treaty must meet a new standard – whereby the income "emanates from, or is incidental to," a trade or business actively conducted by the resident in the residence state – rather than the former "derived in connection with" test. Unlike the 2015 Draft, the 2016 Model Treaty allows activities to be attributed from connected persons.

Further guidance will be included in the technical explanation that is expected to be released this spring. The guidance will likely address whether an item of income, in particular an intra-group dividend or interest payment, will meet this new "emanates" test. The preamble also provides an example: Dividends and interest paid by a commodity-supplying subsidiary acquired by a parent whose business in the residence state depends on a reliable source for that commodity would meet the emanates test, whereas payments between two companies that are merely in similar lines of business would not be sufficient to meet this test.

The public is invited to send examples of income for potential inclusion in the technical explanation until April 18, 2016. Unless the provisions are changed after public comments, the mere expansion of a business on a lateral basis from the treaty partner to the U.S. may not be sufficient meet the active trade or business exception in the absence of active management by the parent.

Additionally, the 2016 Model Treaty specifies additional activities that are excluded from the active trade or business test: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing group financing (including cash pooling); and (iv) making or managing investments, unless carried on by a bank, insurance company, or registered securities dealer in the ordinary course of its business as such.

Derivative Benefits Test Added

While the 2006 Model Treaty did not provide for a derivative benefits test (only a standalone ownership/base erosion test, on which the derivative benefits test is based), a form of this test is included in existing U.S. tax treaties with most countries and Canada.[8] However, existing treaties limit third-country ownership to seven or fewer "equivalent beneficiaries," meaning residents of a member country of the E.U. or N.A.F.T.A. (the North American Free Trade Agreement).

The derivative benefits clause in existing U.S. treaties generally allows a company that cannot otherwise qualify for treaty benefits to obtain treaty relief if

- the company is at least 95% owned by shareholders that are residents of other countries having a comprehensive income tax treaty with the U.S. (a "Shareholder Treaty");
- the Shareholder Treaty would allow the shareholders to claim treaty benefits with respect to the underlying income if it was paid directly to them; and
- with respect to dividends, interest or royalties, the benefits accorded to the shareholders under the Shareholder Treaty are equal to, or better than, the benefits the company will obtain under the treaty in issue.

This posed a problem under the 2015 Draft for holding companies in one country owned by individuals resident in a second country having a treaty with the U.S. With regard to dividends, individuals are eligible only for a 15% withholding tax, not a 5% withholding tax or an exemption. A similar problem existed for corporations owning less than 10% of the holding company. This has now been eliminated.[9]

The 2016 Model Treaty adds a derivative benefits clause to the model L.O.B. article. This new provision accomplishes the following:

- It removes the geographic restriction found in the derivatives benefit provision of existing treaties.
- It allows a corporation owned by individuals and others to benefit from the withholding tax applicable to the shareholder if payments were made diretly to the shareholder.

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8 *E.g.*, a derivative benefits provision was added to the Germany-U.S. Income Tax Treaty in a 2006 protocol, which amended Article 28 (the L.O.B. provisions) to include a new Article 28(3).

9 *2016 Model Treaty*, art. 10(6).

- If a corporation is engaged in the active conduct of a trade or business in its country of residence that is substantial in relation, and similar or complementary, to the trade or business in the U.S., the individual is treated as if he or she were a company for purposes of the rate equivalency test.

In addition, the derivative benefits test includes a base erosion test, that is similar to the test applicable to a subsidiary of a publicly traded company. Consequently, the base erosion test must be met by the group as a whole and not just the company seeking benefits.

Headquarters Company Category Adopted

The 2016 Model Treaty adds a new test allowing a company that qualifies as a "headquarters company" to claim treaty benefits for dividends and interest paid by members of its multinational group. This test requires that the company's "primary place of management and control" must be in its country of residence. This is a heavier burden to meet than the existing test, which looks to the exercise of supervision and administration functions in the country of residence. According to the preamble, the presence in the treaty country of strategic, financial, and operational policy decision-making for a multinational group establishes sufficient nexus to that country with respect to dividends and interest.

"The 2016 Model Treaty adds a new test allowing a company that qualifies as a 'headquarters company.'"

To qualify as a headquarters company, the multinational group must consist of companies resident in at least four countries, all engaged in the active conduct of a trade or business and certain income tests must be met. A base erosion test must be met that is comparable to other provisions within the L.O.B. article.

It should be noted that treaty benefits for headquarters companies are capped in the 2016 Model Treaty. A headquarters company is entitled to benefits only with respect to dividends and interest paid by members of its multinational corporate group. In the case of interest, withholding tax is not eliminated; rather, it is capped at 10%.[10]

CONCLUSION: PLAN WITH THE 2016 MODEL TREATY IN MIND

The 2016 Model Treaty signals the latest view on treaty and protocol negotiation. Some of its changes are helpful, such as the addition of a derivative benefits clause and a headquarters exception. However, other changes will be problematic for certain taxpayers, such as adding a base erosion test in some cases and an active trade or business test that may be more difficult to meet. Moreover, reflecting the complexities of a post-B.E.P.S. world, provisions in the 2016 Model Treaty are drafted in a Byzantine manner to ensure prevention of abuse by aggressive planners.

10 *Id.*, art. 11(2)(f).

2016 MODEL TREATY – MANDATORY ARBITRATION

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Tags
Action 14
B.E.P.S.
Mandatory Arbitration
O.E.C.D. Model Treaty
Tax Treaties
U.S. Model Income Tax Treaty

In the newly released U.S. Model Income Tax Convention ("2016 Model Treaty"), a provision was made for "mandatory arbitration" to resolve disputes. The mandatory arbitration provision is designated in Article 25 (Mutual Agreement Procedure).

IN GENERAL

In general, competent authority provisions in most U.S. tax treaties require that parties attempt to resolve treaty disputes between themselves, but generally, they do not mandate an agreement. The 2016 Model Treaty, along with several newly-signed U.S. tax treaties, includes a mandatory arbitration provision. However, most existing treaties contain arbitration provisions that are non-binding.

The U.S. believes that a mandatory arbitration provision will incenti*vize* parties to resolve their disputes before the actual arbitration proceeding. Based on results from the U.S.-Canada Income Tax Treaty, the I.R.S. estimates that 80% of the cases that were scheduled for arbitration were settled in advance due to that treaty's mandatory arbitration provision. The U.S. estimates that mandatory arbitration will resolve disputes in six to nine months, a timeframe which is considerably faster than current alternative treaty dispute resolution options.

2016 MODEL TREATY HIGHLIGHTS

Local Law

The 2016 Model Treaty contains language that supersedes procedural limitations in domestic law. Additionally, collection procedures are suspended during the arbitration period.[1]

Mandatory Arbitration Process

The arbitration board is comprised of three members who may only consider resolutions presented by the parties. The board may not provide its own resolution to the dispute.

In order to submit a case to arbitration, the following conditions must be satisfied:

- Tax returns have been filed for the years in question with one of the treaty countries.
- Two years have passed since the commencement date of the case, unless

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1 U.S. Department of the Treasury, U.S. Model Income Tax Convention, (Feb. 17, 2016), art. 25(2).

the competent authorities agree to a different date.

- The taxpayer has submitted a written request to proceed to binding arbitration.
- A decision on the matter has not already been made by a tribunal or a court.[2]

Appeal Process

Should the taxpayer disagree with the arbitration panel's decision, the taxpayer will have 45 days to appeal the ruling.[3] The taxpayer may then proceed with other alternative dispute resolution procedures, such as court litigation or voluntary amnesty programs.

COMPARISON TO OTHER U.S. TAX TREATIES

Canada

The U.S.-Canada Income Tax Treaty contains many of the same elements of the 2016 Model Treaty, with some significant differences. First, both Canada and the U.S. must agree that the subject matter is suitable for arbitration. Subject matter suitable for arbitration is explicitly enumerated in the 2010 memorandum of understanding between the two countries.[4] Secondly, rules concerning the appeals process are not explicit in the U.S.-Canada treaty or its protocols, contrary to the 2016 Model Treaty, which specifically describes these matters.

Germany

The U.S.-Germany Income Tax Treaty has an arbitration clause similar to the one established in the Canadian treaty. However, the U.S.-German arbitration process is much more detailed than the one established under the Canadian treaty. While the German treaty provides for the composition of the arbitration board in a manner similar to the 2016 Model Treaty, it does not mention the appeals process in the same detailed manner.[5]

O.E.C.D. Model Treaty

The O.E.C.D. includes a mandatory arbitration article in its 2014 O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty").[6] Under the O.E.C.D. Model Treaty, a party is able to apply for mandatory arbitration if an issue has not been resolved within two years from the presentation of the matter

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[2] *Id.*, art. 25(7).

[3] *Id.*, art. 25(9)(k).

[4] Memorandum of Understanding Between the Competent Authorities of Canada and the United States of America, art. 26(6)(b), Nov. 8, 2010.

[5] U.S. Department of the Treasury, *Technical Explanation of the Convention and Protocol Between the United States of America and the Federal Republic Of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes On Income and Capital and to Certain Other Taxes*, (1989), art. 25.

[6] O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014), art. 25(5).

to the competent authority. Similar to the new U.S. provisions, the O.E.C.D. Model Treaty states that mandatory arbitration cannot occur if the matter is resolved by a court or tribunal in advance of arbitration. The decision is binding on both parties, notwithstanding procedural time limits in the domestic country of either state.

A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board. While these matters are explicitly described in the 2016 Model Treaty, the O.E.C.D. Model Treaty allots the actual process and structure to the competent authorities of each treaty country.

"A key difference between the O.E.C.D. Model Treaty and the 2016 Model Treaty is the appeals process and the composition of the arbitration board."

B.E.P.S. CONCERNS REGARDING MANDATORY ARBITRATION

Action 14 of the O.E.C.D.'s B.E.P.S. Action Plan acknowledges several concerns with regard to mandatory arbitration clauses. Firstly, mandatory arbitration removes national sovereignty through the superseding effect of treaties over domestic procedural limitations. Secondly, the power of mandatory arbitration boards may be too broad and some countries may wish to constrain an arbitrator's power over certain issues. Practitioners should note that the U.S. has demonstrated a similar concern, as evidenced by this exact limitation in the arbitration clause of the U.S.-Canada treaty.

CONCLUSION

Based on recently signed U.S. tax treaties, the mandatory arbitration clause will be an essential part of U.S. tax treaties going forward. Practitioners should focus on details relating to the composition of the arbitration panel and the appeals process. These two provisions often result in the biggest divergence between the 2016 Model Treaty and an actual effective treaty when signed.

2016 MODEL TREATY – B.E.P.S. & EXPATRIATED ENTITIES

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Tags
Action 6
Action 7
B.E.P.S.
Connected Person
Expatriated Entity
O.E.C.D. Model Treaty
Permanent Establishment
Tax Treaties
U.S. Model Income Tax Treaty

INTRODUCTION

The Treasury released a revised version of the U.S. Model Income Tax Convention (the "Model Treaty") on February 17, 2016 ("2016 Model Treaty"). The 2016 Model Treaty includes many technical improvements developed during tax treaty negotiations and implements efforts to eliminate double taxation while fighting base erosion and profit shifting ("B.E.P.S.").

TACKLING B.E.P.S.

In order to effectively tackle B.E.P.S. under the G-20/O.E.C.D. initiative (the "B.E.P.S. Project"), many of the deliverables call for legislative reform and incorporation into tax treaties. B.E.P.S. Action 6 specifically looks at treaty abuse and the role treaties have played in triggering non-taxation. The 2016 Model Treaty reflects the Treasury's preference for addressing B.E.P.S. through changes in objective rules applied prospectively. Although certain O.E.C.D. recommendations were already a part of the Model Treaty (such as, *e.g.*, comprehensive limitation on benefits provisions), the 2016 Model Treaty incorporates other recommendations for the first time.

The 2016 Model Treaty directly states that both treaty partners aim to eliminate double taxation of income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Eliminating double taxation maintains a competitive global economy, but taxpayers have often taken advantage of these measures to ensure that no tax is paid in either of the contracting states. While eliminating double taxation has always been the objective of the bilateral tax conventions, expressing a clear intent to counteract non-taxation or reduced taxation through evasion or avoidance declares the need for balance in order to achieve broader fiscal policy goals.

The 2016 Model Treaty incorporates a rule to protect against contract-splitting abuses of the 12-month permanent establishment ("P.E.") threshold for building, construction, or installation projects. Contract splitting occurs when an enterprise divides a contract into several parts, each covering a period of less than 12 months and attributed to a different company, all of which are, however, owned by the same parent company. By so doing, the company avoids creating a P.E., and thus, paying tax as a resident.

The 2016 Model Treaty contains a 12-month ownership and residence requirement for companies to qualify for the 5% withholding rate for direct dividends. This addresses the practice of companies changing residence for the purpose of qualifying for the lower rate.

It is worth noting that the 2016 Model Treaty has not adopted the other B.E.P.S. Project recommendations with respect to P.E.'s, *e.g.*, the revised rules related to dependent and independent agents and the exemption for preparatory and auxiliary activities under B.E.P.S. Action 7 ("Action 7"). Action 7 stresses the need to update the definition of a P.E. in order to prevent artificial avoidance of P.E. status through the use of intermediary agents and the performance of preparatory and auxiliary activities.

Under the 2016 Model Treaty, a P.E. is established when a nonresident company has a fixed place of business or a dependent agent concluding contracts on its behalf in a foreign country. Companies may avoid creating a P.E. through their agents (without materially changing the functions performed in the country) by changing the terms of contracts, thus showing that these agents did not conclude and bind the principal. In addition, there is a carve-out rule for independent agents, whereby no P.E. is created if the agent is found to be legally and economically independent and acting in the ordinary course of business.

Action 7 proposes that where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. Action 7 recommends that a P.E. should be deemed to be created when, on behalf of an enterprise, a person both (i) has and habitually exercises an authority to conclude contracts and (ii) habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. These may be contracts (i) in the name of the enterprise; (ii) for the transfer of ownership of, or the granting of the right to use, property that is owned by the enterprise, which the enterprise has the right to use; or (iii) for the provision of services by the enterprise. A P.E. would be created under these circumstances unless the activities of such person are exercised through a fixed place of business that would not be considered to establish a P.E. This proposal maintains the exclusion for independent agents, but the carve-out rule does not apply to exclusive independent agents that are closely related to the enterprise and are not considered independent agents by virtue their activities.

"Exceptions to the creation of a P.E. for certain activities... have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary."

The O.E.C.D. Model Tax Convention on Income and on Capital (the "O.E.C.D. Model Treaty") provides exceptions to the creation of a P.E. for certain activities – generally activities considered to be preparatory or auxiliary. These exceptions have changed the way business is conducted by limiting the core activities being performed in a country to those that can be deemed as preparatory or auxiliary, *i.e.*, not the types that create a P.E. These exceptions have often led to the fragmentation of cohesive operating businesses into smaller, separate operations so that each unit is merely engaged in preparatory or auxiliary activities that avoid creating a P.E.

Action 7 proposes limiting the exemption for preparatory and auxiliary activities. It provides a more selective test than the O.E.C.D. Model Treaty and excludes a number of fixed places of business, which should not be treated as P.E.'s because the business activities exercised through these places are merely preparatory or auxiliary. These provisions prevent the creation of a P.E. in a state if the enterprise only carries out activities that are purely preparatory or auxiliary in nature an ensure that preparatory or auxiliary activities carried on at a fixed place of business are viewed in the light of other complementary operations that are part of a cohesive business.

The Treasury has said it will continue to look at the P.E. recommendations under the B.E.P.S. Project and the concerns raised by the O.E.C.D.

EXPATRIATED ENTITIES

The Model Treaty aims to reduce the tax benefits of corporate inversions by denying treaty benefits for U.S. withholding taxes on U.S.-source dividends, interest, royalties, and certain guarantee fees paid by U.S. companies that are "expatriated entities," as defined under the Internal Revenue Code ("Code").

Under Code §7874(a)(2)(A) the term "expatriated entity" generally means (i) the domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation, and (ii) any U.S. person who is related to a domestic corporation or partnership described in (i) above. A "surrogate foreign corporation" is an acquiring foreign corporation or foreign publicly traded partnership that has acquired a U.S. corporation or partnership under the rules described in Code §7874(a)(2)(B).

An expatriated entity is one that has been acquired by a foreign entity in a country where the business activities are not substantial when compared to those of the affiliated group. However, the shift of ownership residency may offer lower withholding taxes or certain other tax benefits.

Under the 2016 Model Treaty, the Model Treaty provisions (discussed above) will apply only when the beneficial owner of a dividend, interest payment, royalty, or guarantee fee is a connected person with respect to the expatriated entity.

Further, the definition of expatriated entity is fixed to the definition under Code §7874(a)(2)(A) as of the date a treaty is signed, in order to match the scope with any future changes to the Code.

Under certain circumstances, pre-existing U.S. subsidiaries of a foreign acquirer would not be considered expatriated entities.

POLICY IMPLICATIONS

As noted above, the Treasury has decided not to adopt the O.E.C.D. recommendations regarding dependent and independent agents and exemptions for preparatory and auxiliary activities at this point. It should be remembered that any changes to the Model Treaty should be globally understood and uniformly applied by the contracting states. Action 7 addresses the challenges that countries create for P.E.'s in the jurisdictions where they operate. However, the directive still leaves open a number of questions, such as the scope of the P.E. test. The Treasury is not willing to adopt these P.E. rules before creating a common global understanding and developing ways to ease the compliance burdens that Action 7 could create.

While the revisions regarding expatriated entities generally restrict treaty benefits, the 2016 Model Treaty also exempts previously existing U.S. subsidiaries under certain conditions. Pre-existing U.S. subsidiaries of the foreign acquirer would not be considered expatriated entities for purposes of denying treaty benefits unless the entities join in filing a U.S. consolidated return with the domestic entity, or another entity connected to the domestic entity, after the domestic entity has been acquired. This exemption recognizes that expatriated entities may be multinational corporations with genuine business reasons for having U.S. subsidiaries. By allowing for this concession, the 2016 Model Treaty attempts to balance measures taken to combat B.E.P.S. against the real business operations of multinational corporations.

TAX 101:

CORPORATE REORGANIZATIONS PART II – TYPES C, D, E, & F

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Tags
Corporate Reorganizations
C-reorganization
D-reorganization
E-reorganization
F-reorganization
Meaningless Gesture Doctrine
Substantially All
Voting Stock

In Part I of this series,[1] we discussed A- and B-reorganizations. In this article, we will discuss C-, D-, E-, and F-reorganizations.

C-REORGANIZATIONS

A C-reorganization, otherwise known as a "practical merger," is where a target corporation ("Target") transfers "substantially all" of its properties to an acquiring corporation ("Acquiror") solely in exchange for all or a part of Acquiror's "voting stock,"[2] and Target then liquidates, distributing all of its remaining assets including Acquiror's voting stock, which it just received.[3]

Substantially All

A C-reorganization requires that Target transfer substantially all of its properties to Acquiror. To satisfy this requirement, the transfer should generally represent at least 90% of the fair market value of Target's net assets and at least 70% of the fair market value of Target's gross assets held by Target immediately prior to the transfer.[4]

Solely for Voting Stock

The phrase "solely for…voting stock" has the same meaning as in a B-reorganization. Generally, voting stock plus some other consideration does not meet the statutory requirement. As a general principle, the assumption of a liability in an acquisition is treated as additional consideration (*i.e.*, as "boot") to the transferor. Thus, if Acquiror assumes any of the liabilities of Target in the acquisition, it would be treated as if Target received boot. However, the statute specifically provides that for C-reorganization purposes, Acquiror's assumption of Target's liabilities is not considered boot.[5]

Boot Relaxation Rule

For a C-reorganization, there is an exception to the solely for voting stock requirement

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1 Rusudan Shervashidze and Andrew P. Mitchel, "Tax 101: Corporate Reorganizations Part I – Types A & B," *Insights* 2 (2016).

2 In certain types of reorganizations that are often referred to as "triangular" reorganizations, the voting stock of the parent of Acquiror can be used in lieu of the voting stock of Acquiror. This article does not discuss triangular reorganizations.

3 Code §§368(a)(1)(C) and 368(a)(2)(G).

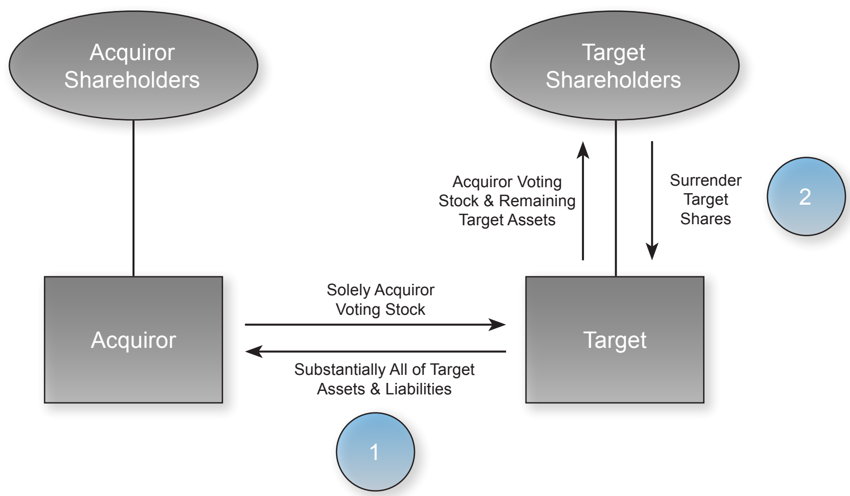
4 Rev. Proc. 77-37, 1977-2 C.B.568.

5 Code §368(a)(1)(C).

that is often referred to as the "boot relaxation rule."[6] Under this rule, an acquisition with partial non-voting stock consideration can still qualify as a C-reorganization as long as at least 80% of the fair market value of the total consideration received by Target is voting stock of Acquiror. In making this computation, however, liabilities of Target assumed by Acquiror are considered boot.[7] Another way to think of the boot relaxation rule is that the Acquiror is permitted to transfer some non-voting stock consideration to Target as long as the fair market value of both that non-voting stock consideration and the assumption of Target's liabilities does not exceed 20% of the total value going to Target.

As stated above, a C-reorganization takes place in two steps: First, Target transfers substantially all of its properties to Acquiror solely in exchange for all or a part of Acquiror's voting stock, and second, Target liquidates. In the first step, Acquiror recognizes no gain or loss on the receipt of the property in exchange for its stock,[8] and Target recognizes no gain or loss on the receipt of Acquiror's stock.[9] Acquiror takes the same bases in Target's assets as when the property was in Target's hands.[10] In the second step, Target recognizes no gain or loss on the distribution.[11] Target's shareholders recognize gain equal to the lesser of gain realized or boot received.[12] For Target's shareholders, the bases in Acquiror stock received are generally the same as the bases in Target stock exchanged.[13]

Diagram of a C-reorganization



If the reorganization meets the C-reorganization requirements above and at the same time qualifies as a D-reorganization under Code §368(a)(1)(D), then the reorganization must be treated as a D-reorganization.[14]

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6 Code §368(a)(2)(B).

7 Code §368(a)(2)(B), flush.

8 Code §1032.

9 Code §361(a) and (b).

10 Code §362(b).

11 Code §361(c).

12 Code §354.

13 Code §358.

14 Code §368(a)(2)(A).

D-REORGANIZATIONS

A D-reorganization is a transfer by a corporation of all or part of its assets to another corporation if, immediately after the transfer, the transferor or its shareholders are in control of the corporation to which the assets are transferred, but only if in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under Code §§354, 355, or 356.[15]

"D-reorganizations can be acquisitive or divisive in nature..."

D-reorganizations can be acquisitive or divisive in nature. A D-reorganization is acquisitive when one corporation ("Target") transfers substantially all of its assets to another corporation ("Acquiror") and pursuant to the plan Target liquidates, distributing all of its assets, including the stock or securities received from Acquiror, to its shareholders.[16] Generally, a D-reorganization is divisive when a corporation ("Distributing") transfers part of its assets to a controlled corporation ("Controlled"), and the transfer is followed by the distribution of the shares of Controlled to the shareholders of Distributing.[17] This article does not address divisive reorganizations. For more on Divisive D-reorganizations and the requirements under Code §355, please see our article "Tax 101: How to Structure a Corporate Division."[18]

Acquisitive D-reorganizations

As described above, there are two steps in an acquisitive D-reorganization. First, Target transfers substantially all of its properties to Acquiror, and second, Target liquidates. Note the similarity of acquisitive D-reorganizations to C-reorganizations described above. C- and acquisitive D-reorganizations are both "asset" reorganizations and are both acquisitive in nature. Thus, the tax analysis of both of these types of reorganizations is very similar. A difference, however, is that C-reorganizations have the solely for voting stock requirement and D-reorganizations do not.

In the first step of an acquisitive D-reorganization, Acquiror recognizes no gain or loss on the receipt of the property in exchange for its stock,[19] and Target recognizes no gain or loss on the receipt of Acquiror's stock.[20] Acquiror takes the same bases in Target's assets as when the property was in Target's hands.[21]

In the second step, Target recognizes no gain or loss on the distribution.[22] Target's shareholders recognize gain equal to the lesser of gain realized or boot received.[23] For Target's shareholders, the bases in Acquiror stock received are generally the same as the bases in Target stock exchanged.[24]

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15 Code §368(a)(1)(D).

16 Code §§368(a)(1)(D) and 354(b)(1).

17 Code §§368(a)(1)(D) and 355.

18 Elizabeth Zanet, *Insights* 10 (2015).

19 Code §1032.

20 Code §361(a) and (b).

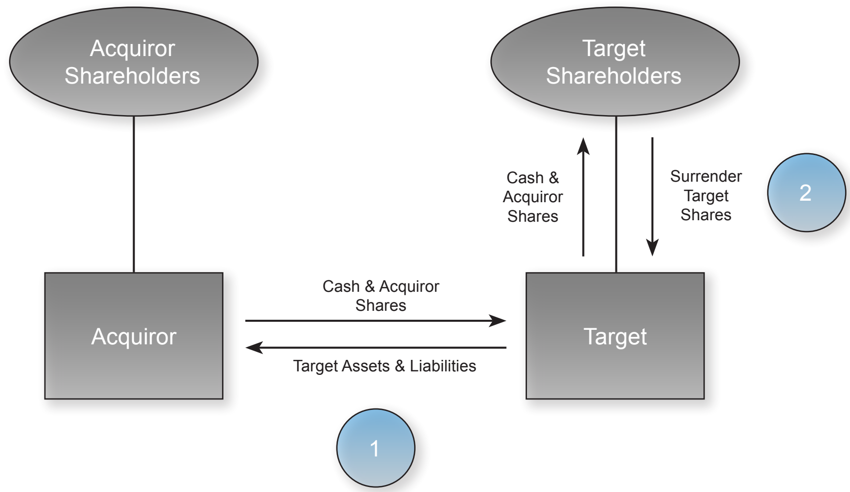
21 Code §362(b).

22 Code §361(c).

23 Code §354.

24 Code §358.

Diagram of an Acquisitive D-reorganization



"In the international context, it is common to restructure foreign entities in a way that can qualify as a D-reorganization through the use of the 'check-the-box' rules."

In a D-reorganization, the Acquiror shareholders are often the same persons as the Target shareholders.

Meaningless Gesture Doctrine

Notwithstanding the requirement in a D-reorganization that "stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356," the I.R.S. and the courts have not required the actual issuance and distribution of stock and/or securities of the transferee corporation in circumstances where the same person or persons own all the stock of Target and Acquiror. In these circumstances, the I.R.S. and the courts have viewed an issuance of stock by Acquiror to be a "meaningless gesture" not mandated by Code §§368(a)(1)(D) and 354(b).[25]

In the international context, it is common to restructure foreign entities in a way that can qualify as a D-reorganization through the use of the "check-the-box" rules. A typical example includes a single shareholder ("Shareholder") that wholly owns two foreign corporations ("Foreign Acquiror" and "Foreign Target"), which are treated as controlled foreign corporations. If, pursuant to a plan, Shareholder contributes the shares of Foreign Target to Foreign Acquiror and then a check-the-box election is made to treat Foreign Target as a disregarded entity, the combined steps may be treated as a D-reorganization.

For U.S. tax purposes, prior to the transactions there were two separate corporations. After the transactions, (because Foreign Target is now treated as a disregarded entity) in the eyes of U.S. tax law there is only one corporation – Foreign Acquiror. Foreign Acquiror has acquired all of the assets of Foreign Target, and Foreign Target is no longer taxed as a corporation for U.S. tax purposes. This type of planning, however, should not be undertaken without a thorough U.S. tax analysis to assure that the desired U.S. tax result will be achieved.

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[25] See *James Armour, Inc. v. Commr.*, 43 T.C. 295, 307 (1964); *Wilson v. Commr.*, 46 T.C. 334 (1966); Rev. Rul. 70-240, 1970-1 C.B. 81.

E-REORGANIZATIONS

An E-reorganization, also refered to as a "recapitalization," involves a single corporation that is undertaking a readjustment, or reshuffling,[26] of its capital structure. For example, an E-reorganization may include a corporation changing the mix of its debt/equity structure.

Typically, an E-reorganization involves exchange of bonds for stock, bonds for bonds, or stock for stock. Unlike most other reorganizations, an E-reorganization does not need to meet the "continuity of interest" or "continuity of business enterprise" requirements.[27] However, to qualify as an E-reorganization, the transaction must have a valid non-tax business purpose.

The regulations provide five examples of transactions that qualify as recapitalizations (or E-reorganizations):

- A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders.[28]
- There is surrendered to a corporation for cancellation 25% of its preferred stock in exchange for no par value common stock.[29]
- A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock.[30]
- An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights.[31]
- An exchange is made of an amount of a corporation's outstanding preferred stock with dividends in arrears for other stock of the corporation.[32]

F-REORGANIZATIONS

An F-reorganization is a mere change of identity, form, or place of organization of

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26 *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942). The U.S. Supreme Court defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."

27 Treas. Reg. §1.368-1(b).

28 Treas. Reg. §1.368-2(e)(1).

29 Treas. Reg. §1.368-2(e)(2).

30 Treas. Reg. §1.368-2(e)(3).

31 Treas. Reg. §1.368-2(e)(4).

32 Treas. Reg. §1.368-2(e)(5). However, if pursuant to such an exchange there is an increase in the proportionate interest of the preferred shareholders in the assets or earnings and profits of the corporation, then a deemed distribution may occur under Code §§305(c) and 305(b)(4).

"one" corporation, however effected.[33] Since 1982,[34] the statute specifically provides that an F-reorganization must involve one corporation. One court has described the F-reorganization as follows:

> [The F-reorganization] encompass[es] only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences. For instance, the (F) reorganization typically has been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution.[35]

Although a transaction will generally not qualify as an F-reorganization if there is any change to the existing shareholders or in the assets of the corporation, the I.R.S. has ruled that the failure of dissenting shareholders owning less than 1% of the outstanding shares to participate in a merger did not disqualify the merger from being an F-reorganization.[36] Among other things, an F-reorganization can be accomplished by (i) merging one corporation into a new corporation in a different jurisdiction or (ii) contributing corporate shares to a new corporation and liquidating the contributed corporation upstream into its then parent.[37] In 2015, final regulations regarding F-reorganizations were promulgated,[38] which provide six requirements that are necessary to be considered a "mere change" in order to qualify as an F-reorganization:

- Immediately after the potential F-reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the potential F-reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation in the potential F-reorganization.
- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the potential F-reorganization, and of the resulting corporation, determined immediately after the potential F-reorganization, in identical proportions.
- The resulting corporation may not hold any property or have any tax attributes, including those specified in Code §381(c), immediately before the potential F-reorganization.

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33 Code §368(a)(1)(F).

34 Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 325, §225.

35 *Berghash v. Commr.*, 43 T.C. 743, 752 (1965) (citation and footnotes omitted), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

36 Rev. Rul. 66-284, 1966-2 C.B. 115.

37 Treas. Reg. §1.368-2(m)(4), Ex. 5.

38 T.D. 9739.

- The transferor corporation must completely liquidate, for Federal income tax purposes, in the potential F-reorganization.
- Immediately after the potential F-reorganization, no corporation other than the resulting corporation may hold property that was held by the transferor corporation immediately before the potential F-reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code §381(c).
- Immediately after the potential F-reorganization, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in Code §381(c).[39]

"F-reorganizations are often utilized in foreign reorganizations where a corporation desires to change its country of organization from one country to another."

Similar to E-reorganizations, F-reorganizations do not need to meet the continuity of interest or continuity of business enterprise requirements.[40]

F-reorganizations are often utilized in foreign reorganizations where a corporation desires to change its country of organization from one country to another. The I.R.S. has held that the objective of relocating from one foreign jurisdiction to another to reduce foreign income taxes qualified as a valid business purpose.[41]

A change in the place of organization of a corporation is not necessarily treated as a transfer of assets from the "old" corporation to the "new" corporation. However, if a U.S. corporation changes its place of organization so as to become a non-U.S. corporation, the regulations deem that a transfer of assets occurs, from the old U.S. corporation to the new foreign corporation.[42] Similarly, if a foreign corporation changes its place of organization so as to become a U.S. corporation, the regulations deem that a transfer of assets occurs, from the old foreign corporation to the new U.S. corporation.[43] These deemed transfers can trigger gain or income inclusions under the special rules of Code §367.[44]

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39 Treas. Reg. §1.368-2(m)(1).

40 Treas. Reg. §1.368-1(b).

41 P.L.R. 200626037.

42 Treas. Reg. §1.367(a)-1(f).

43 Treas. Reg. §1.1.367(b)-2(f).

44 Code §367 will be discussed further in upcoming articles.

CORPORATE MATTERS:
ANATOMY OF A LIMITED LIABILITY COMPANY AGREEMENT – PART I

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Tags
Corporate Law
Delaware
Entity Formation
L.L.C.
New York
Operating Agreement

BACKGROUND

When the acquisition structure calls for the formation of a limited liability company ("L.L.C."), we typically recommend Delaware or New York (for clients doing business in New York[1]) as the jurisdiction in which to form the entity.

Once the structure is agreed upon, our clients generally ask us to form the L.L.C. and draft the relevant governance documentation, which in New York is referred to as the "operating agreement" and in Delaware law as the "limited liability company agreement." In practice, however, the terms are used interchangeably, and for purposes of this article, we will use the term "Operating Agreement" as it is more commonly used.

Following formation of the L.L.C., clients frequently request copies of the memorandum and articles of association, bylaws, and stock certificates with respect to the newly-formed entity. None of the above documents are mandatory or common with respect to an L.L.C. The equivalent of all such documents is the Operating Agreement itself. This article is the first in a series explaining what an Operating Agreement is and describing the key provisions one typically sees in an Operating Agreement.

OPERATING AGREEMENT

An Operating Agreement is the L.L.C. equivalent of a partnership agreement, except that the owners are referred to as members when the entity is an L.L.C., or a shareholders' agreement among the owners of a corporation. Although owners of a corporation are not required to enter into a shareholders' agreement, the New York Limited Liability Company Act requires that members enter into a written Operating Agreement.[2] In Delaware, an Operating Agreement is also required, but it may be implied, written, or oral.[3]

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1. Simon H. Prisk, "Corporate Matters: Are You Doing Business New York L.L.C.?," Insights 8 (2015): pp. 35-37.

2. N.Y. Limited Liability Company Law §417(a): Subject to the provisions of this chapter, the members of an L.L.C. shall adopt a written Operating Agreement that contains any provisions, which are not inconsistent with the law or its articles of organization, relating to (i) the business of the L.L.C.; (ii) the conduct of its affairs; and (iii) the rights, powers, preferences, limitations, or responsibilities of its members, managers, employees, or agents, as the case may be.

3. See the definition of "limited liability company" in Delaware Limited Liability Company Act §18-101(7).

FORMATION, PURPOSE, AND POWERS

Most Operating Agreements follow a common form. The initial sections of the agreement deal with the formation of the company. An L.L.C. is not formed by the signing of the Operating Agreement, and typically, the company will have been formed previously by the filing of a certificate of formation or organization with the Secretary of State. The date of formation and the jurisdiction in which it was formed are set forth in the Operating Agreement.

"An L.L.C. may be managed by the members, a manager appointed by the members, a board of managers, or a combination of the three."

The following sections of the Operating Agreement typically cover the purpose for which the company was formed and the powers that the company will possess. Often, these sections are taken from the state statute in the jurisdiction where the company was formed. Alternatively, a generic statement in the Operating Agreement will provide that the company's purpose and powers are as provided in the relevant statue.[4] In other words, the L.L.C. may engage in any business that may be carried on legally by an L.L.C.

If the company is a wholly-owned subsidiary, precisely defining the purpose of the company may not be necessary, as such matters will typically be dealt with between the owners of the parent company. However, if the company is being formed as an entity through which a joint venture will operate, it may be important to accurately define the purpose of the company. To illustrate, if a joint venture is formed to buy real estate, the co-venturers will want to make sure that the entity does not carry on an active program of trading in stocks and securities. Also, if there is a desire to make sure that none of the joint venture partners compete against the company, it is helpful to clearly state purpose of the company so that provision can be made elsewhere in the Operating Agreement preventing members of the company from conducting a competing business or preventing them from being an owner of a business that competes with the company.

MANAGEMENT

An L.L.C. may be managed by the members, a manager appointed by the members, a board of managers, or a combination of the three.

Typically, a single-member L.L.C. or a multiple-member company owning a small business will be managed by the members. This means that all owners share responsibility for the day-to-day management of the entity.

Companies with more substantial businesses and two or more members may want to appoint a manager who need not be a member – particularly if some of the members want to be passive. The members may want to have a say on major decisions, and in this instance, the manager may be given the power to run the day-to-day operations of the company but will be required to seek the approval of the members in order to carry out an atypical action.

A board of managers or an advisory board may also be appointed to oversee the management of the company. In this instance, management would need to consult with the board on certain business decisions outside the ordinary course of business.

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[4] *E.g.*, Delaware Limited Liability Company Act §18-106.

CAPITAL CONTRIBUTIONS

Members of an L.L.C. contribute capital to the company typically, but not necessarily, based on their ownership shares, which can be expressed as a percentage or by the issuance of ownership units. Service providers receiving a so-called profits interest in the L.L.C. are not usually required to contribute capital. Unit certificates can be obtained if desired, but typically the ownership interest in an L.L.C. is set forth as a percentage in an exhibit to the Operating Agreement.

Contributions to capital may be made in the form cash or property. Property contributions are listed and described, and the managing member or members agree on the fair market value of such property.

Each member of an L.L.C. has a capital account, which is credited with the initial capital contribution and any additional capital contributions. A full description of capital accounts will appear in Part II of this article, where allocations and distributions will also be discussed.

This section of the Operating Agreement will also cover additional capital contributions, if any, and set forth how the additional contributions can be called and the consequences of non-payment. Note also that members may loan money to the company, separate from their capital accounts.

TRANSFERS

As in a shareholders' agreement, an important provision in an Operating Agreement is the provision setting out transfer restrictions. A member may be completely prohibited from transferring his or her ownership interest, or a member could be subject to any one of a number of transfer restrictions – as mentioned in previous articles – including right of first refusal or offer, drag-along or tag-along rights, and shotgun buy/sell provisions.

In Part II of this series, we will discuss capital accounts, allocations and distributions, and the standard boilerplate provisions contained in an Operating Agreement.

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Tags
F.A.T.C.A.
F.F.I.
I.G.A.
Reporting Requirements

CHANGES TO F.A.T.C.A. REGULATIONS WILL EASE BURDENS ON F.F.I.'S

In January 2016, the I.R.S. published Notice 2016-8, in which it announced that it intends to amend some of the regulations with respect to both Chapter 3 – Withholding of Tax on Nonresident Aliens and Foreign Corporations and Chapter 4 – F.A.T.C.A. Withholding. The intended changes include

- modification of the date for submitting to the I.R.S. the pre-existing account certifications required for certain foreign financial institutions ("F.F.I.'s");
- specification of the period and date for submitting to the I.R.S. the periodic certification of compliance described in the F.A.T.C.A. regulations for a Registered Deemed-Compliant F.F.I.;
- modification of the transitional information reporting rules for accounts of Nonparticipating F.F.I.'s to eliminate the requirement to report on gross proceeds for the 2015 year; and
- specification of the circumstances under which a withholding agent may rely upon electronically-furnished W-8 forms (*i.e.*, withholding certificates) and Forms W-9, *Request for Taxpayer Identification Number and Certification*, collected by intermediaries and flow-through entities.

Before the ink was dry, the I.R.S. corrected the notice in February on two favorable points. The first change clarifies that the additional time allowed for a Participating F.F.I. or Reporting Model 2 F.F.I. to provide pre-existing account certifications includes the F.F.I.'s certification that it did not have practices and procedures to assist account holders in the avoidance of Chapter 4. The second change removes an incorrect reference to a regulation.

Until changes are formally adopted in the regulations, taxpayers may rely on the notice.

TREASURY FINALIZES DOMESTIC ENTITY REPORTING REGULATIONS

Pursuant to Code §6038D(a), which was enacted as part of F.A.T.C.A., the I.R.S. developed Form 8938, *Statement of Specified Foreign Financial Assets*, which individuals use to report certain financial assets held offshore. Code §6038D(f) allowed the I.R.S. to extend reporting to certain domestic entities. On February 22, 2016, the I.R.S. adopted final regulations implementing entity reporting. The new entity reporting rules apply to taxable years beginning after December 31, 2015.

Section 6038D(f) provides that §6038D reporting applies to domestic entities formed or used for purposes of holding specified foreign financial assets. Under the previously issued Prop. Treas. Reg. §1.6038D-6(b)(1)(iii), a corporation or partnership was treated as if it was formed for the purpose of holding specified foreign financial assets if it had over 50% passive assets or if at least 10% of the assets were passive and it was formed with the principal purpose of avoiding reporting under Code §6038D. The final regulations eliminate the principal purpose test for determining whether Code §6038D applies under §6038D(f).

SWISS ATTORNEYS' CONFIDENTIAL CLIENT ESCROW ACCOUNTS EXEMPT FROM F.A.T.C.A.

Pursuant to an amendment to Annex II of the I.G.A. between the U.S. and Switzerland dated March 1, 2016, Swiss financial institutions ("F.I.'s") are exempt from certain F.A.T.C.A. reporting requirements regarding confidential accounts held by Swiss attorneys. This exemption reflects the terms of the Swiss banking industry's Due Diligence Agreement, a self-regulatory code of conduct overseen by the Swiss Financial Market Supervisory Authority. Under the exemption, Swiss F.I.'s do not have to identify clients associated with accounts held by lawyers or notaries in the ordinary course of business as long as they provide written verification that the accounts fall within the scope of the exception clause in Annex II of the I.G.A. Examples of accounts which will fall within the scope of this exemption are accounts held in escrow after the settlement of a lawsuit, funds kept for holding a retainer, and funds held in escrow to facilitate inheritance or divorce, among other purposes.

"Swiss F.I.'s do not have to identify clients associated with accounts held by lawyers or notaries in the ordinary course of business as long as they provide written verification that the accounts fall within the scope of the exception clause."

HUNGARY TO EXPLAIN DUE DILIGENCE PROCEDURES

The Hungarian Tax and Customs Administration recently enacted a law implementing automatic exchange of tax information under F.A.T.C.A. and the E.U. Directive (for the Common Reporting Standard). Under the new law, certain information must be reported to the tax authorities in certain forms by February 15 of each year. The announcement issued last month explained how to comply with this law and provided that the tax authority will impose a penalty of 2 million Hungarian forints (currently, U.S. $7,200) for non-compliance with the deadline for filing certain forms.

I.R.S. STILL INTERESTED IN PUBLIC COMMENTS ON F.A.T.C.A.

Despite the fast-approaching, six-year anniversary of F.A.T.C.A., the I.R.S. is still interested in receiving public comments on reporting under F.A.T.C.A., according to Nancy Lee, senior technician reviewed, Office of Chief Counsel (International). The announcement came at the annual meeting of the Federal Bar Association Section on Taxation in Washington on March 4, 2016.

COMPETENT AUTHORITY AGREEMENTS REACHED WITH SEVERAL PARTIES TO I.G.A.'S

I.G.A.'s provide that the Competent Authorities of the two parties to the agreement shall enter into an agreement under the mutual agreement procedure provided in the applicable Exchange of Tax Information Agreement in order to establish and prescribe the rules and procedures necessary to implement certain provisions in the I.G.A.

- On March 2, 2016, the Colombian and U.S. Competent Authorities reached the necessary agreement.
- On February 23, 2016, the Brazilian and U.S. Competent Authorities reached the necessary agreement.
- On February 18, 2016, the Italian and U.S. Competent Authorities reached the necessary agreement.

CURRENT I.G.A. PARTNER COUNTRIES

To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 and Model 2 I.G.A.'s. An I.G.A. has become the global standard in government efforts to curb tax evasion and avoidance on offshore activities and to encourage transparency.

At this time, the following countries are Model 1 partners by execution of an agreement or concluding an agreement in principle:

Algeria	Gibraltar	Netherlands
Angola	Greece	New Zealand
Anguilla	Greenland	Norway
Antigua & Barbuda	Grenada	Panama
Australia	Guernsey	Peru
Azerbaijan	Guyana	Philippines
Bahamas	Haiti	Poland
Bahrain	Holy See	Portugal
Barbados	Honduras	Qatar
Belarus	Hungary	Romania
Belgium	Iceland	Saudi Arabia
Brazil	India	Serbia
British Virgin Islands	Indonesia	Seychelles
Bulgaria	Ireland	Slovak Republic
Cabo Verde	Isle of Man	Slovenia
Cambodia	Israel	South Africa
Canada	Italy	South Korea
Cayman Islands	Jamaica	Spain
China	Jersey	St. Kitts & Nevis
Colombia	Kazakhstan	St. Lucia
Costa Rica	Kosovo	St. Vincent & the Grenadines
Croatia	Kuwait	Sweden

“To date, the U.S. has signed, or reached an agreement to sign, more than 100 Model 1 I.G.A.’s.”

Curaçao
Cyprus
Czech Republic
Denmark
Dominica
Dominican Republic
Estonia
Finland
France
Georgia
Germany
Latvia
Liechtenstein
Lithuania
Luxembourg
Macao
Malaysia
Malta
Mauritius
Mexico
Montenegro
Montserrat
Thailand
Trinidad & Tobago
Tunisia
Turkey
Turkmenistan
Turks & Caicos Islands
Ukraine
United Arab Emirates
United Kingdom
Uzbekistan

The countries that are Model 2 partners by execution of an agreement, or concluding an agreement in principle, are Armenia, Austria, Bermuda, Chile, Hong Kong, Iraq, Japan, Macao, Moldova, Nicaragua, Paraguay, San Marino, Switzerland, and Taiwan.

This list will continue to grow.

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State Aid
T.A.X.E. Committee
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A.B.A. RECOMMENDS HIGHER CUBAN COMPENSATION FOR AMERICAN BUSINESSES

President Obama recently announced the re-opening of relations between Cuba and the U.S. However, before the U.S. embargo of Cuba can be removed, several issues must be resolved. One of these issues is the value of compensation that must be paid to American businesses and individuals for property seized by the Castro government.

The A.B.A. (American Bar Association) Tax Section recently recommended that any compensation paid by Cuba should not include tax benefits beyond those previously received by U.S. companies and individuals. Excluding tax benefits from the calculation would undoubtedly raise the amount of compensation that Cuba would pay.

According to the A.B.A., this approach would further American interests in several ways. Firstly, the compensation might amount to $1 billion dollars. Secondly, if the compensation erroneously included tax benefits, the I.R.S. would garner less tax on the reclaimed amount, and claimants might recover funds worth less than the basis in the property before confiscation.

Settling these claims is just one of the issues that must be resolved before the U.S. embargo on Cuba is removed. It is expected that the majority of outstanding Cuban-American disputes will be resolved while President Obama is still in office. If outstanding disputes cannot be resolved during President Obama's administration, a Republican successor may take a "hardline" approach against the re-opening of relations between the U.S. and Cuba.

U.S. HOUSE PANEL DISCUSSES INVERSIONS, EUROPEAN INVESTIGATIONS

During a hearing of the U.S. House of Representative's Ways and Means Committee, Democratic and Republican lawmakers commented on inversions and current European Commission investigations into the tax practices of U.S. multinational enterprises ("M.N.E.'s").

Repatriation of Funds & Inversions

Much of the commentary focused on the unwillingness of U.S. enterprises to repatriate funds back to the U.S. to avoid the 35% U.S. corporate income tax. Republican lawmakers believe this practice will continue so long as the corporate tax rate remains at 35%. Lowering the U.S. corporate tax rate is thus one of the Republican's goals. Democrat lawmakers instead focused on reducing the practice of inversions by limiting the ability of entities to use tax deductible interest payments between related parties to erode a country's tax base. The issue will likely be unresolved until the U.S. presidential elections this year.

European Investigations

Republican lawmakers also inquired about the merit of European Commission's investigations into American multinational enterprises alleging infringements of E.U. "State Aid" rules.[1] Witnesses offered differing opinions as to whether the investigations were "political" in nature or if questions of merit were mostly "hyperbolic exaggerations" by American companies. This hearing corresponds with hearings before the T.A.X.E. Committee of the European Parliament in which officials from U.S. M.N.E.'s, such as Apple and Google, testified on March 15 and 16. These proceedings are intended to be followed by a joint session of Congress and the T.A.X.E. Committee in May.[2]

Tension between the U.S. and the European Commission has definitely increased since State Aid investigations were initiated by the European Commission. Whether the upcoming hearings and joint session will calm the situation remains to be seen.

I.R.S. MAY SEEK PENALTIES IN COCA-COLA TRANSFER PRICING CASE

In the company's ongoing $9.4 billion dispute, Coca-Cola could face a surcharge of up to 40% and as much as $3.3 billion worth of taxes for the years 2007 through 2009, based on alleged undercharging of foreign affiliates for the use of intellectual property.

Coca-Cola claims that it is entitled to prospective penalty protection as a result of a 1996 closing agreement, provided the company follows an agreed-upon transfer pricing method. The company further claims that its compliance was confirmed by the I.R.S. during the past five audits, which covered 11 years through 2006.

The I.R.S., on the other hand, alleges that the closing agreement only applied to parts of the income allocated to Coca-Cola and did not apply to the years in dispute. Although the agency admits that it accepted the use of the closing agreement's transfer pricing method through 2006, it also claims that it had adjusted Coca-Cola's application of the method upon its audit.

The underlying reason for this change in treatment is assumed to be the significant restructuring of Coca-Cola operations, which occurred in previous years and involved the recombination of certain operating divisions and the reorganization of the company's North American activities. Updates on this case will follow.

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1 Beate Erwin and Christine Long, "Apple in Europe – The Uphill Battle Continues," *Insights* 1 (2016): pp. 9-15.

2 *Id.*

U.K. FINDS GOOGLE SETTLEMENT TO BE "DISPROPORTIONATELY SMALL"

The U.K. House of Commons Public Accounts Committee ("the Committee") found the $181 million tax settlement between Alphabet Inc., Google Inc.'s parent company, and the U.K. tax authority, Her Majesty's Revenue and Customs ("H.M.R.C."), to be disproportionately small when compared to the size of Google's business in the U.K. The U.K. is the second largest market for Google after the U.S., but the company claimed that its sales to U.K. clients took place in Ireland in order to avoid corporate tax.

The settlement has been highly criticized because the deal was secret, and without full transparency, its fairness is difficult to judge. Much of the tax in dispute related to transfer pricing rules, and a significant portion of the settlement payment was interest, with no penalty charged. The Committee has requested that H.M.R.C. reopen the settlement if new evidence becomes available.

Additionally, the Committee is calling upon H.M.R.C. to lead the overhaul of international tax rules. They have made recommendations that include consulting with other tax authorities, devoting significant resources to tax investigations, strengthening the penalty regime, and monitoring the outcome of investigations, in order to ensure that multinational corporations are not being favored. These initiatives are in line with O.E.C.D.'s B.E.P.S. Project as well as similar tax transparency and anti-State Aid developments on the level of the E.U. The tax environment for multinational companies is definitely becoming tighter in view of these initiatives, combined with an increased exposure to scrutiny from European tax authorities. Structures that may have been acceptable in the past should be reviewed in light of these developments.

"The U.K. is the second largest market for Google after the U.S., but the company claimed that its sales to U.K. clients took place in Ireland in order to avoid corporate tax."

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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