

Transfer Pricing Updates in the world of TP

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Schedule of Webinar

1. Overview of Transfer Pricing

- What is TP?
- Overview of Israeli TP Regulations

2. Global OECD Digital Tax Agreement for minimum tax 15% and reallocation of profits via TP

- Closer look at OECD Digital Taxation Agreement Pier 1 Focus

3. Draft Bill to significantly amend Transfer Pricing Rules and Regulations in Israel

- New Section 85 B – New documentation requirements (contemporaneous) in line with OECD BEPS
- New Section 85 C – CbC report filing (turnover > 3 billion NIS) in line with OECD BEPS

4. Court Cases and Tax Circulars within Israel with TP implications

- Sephira & Offek Ltd and Daniel Amram vs Jerusalem 3 Assessing Officer – TP Implications
- Income Tax Circular No. 1/2021 – Payment to Parent Company for the Grant of its Stock options to employees of the foreign subsidiary (recharge agreements).

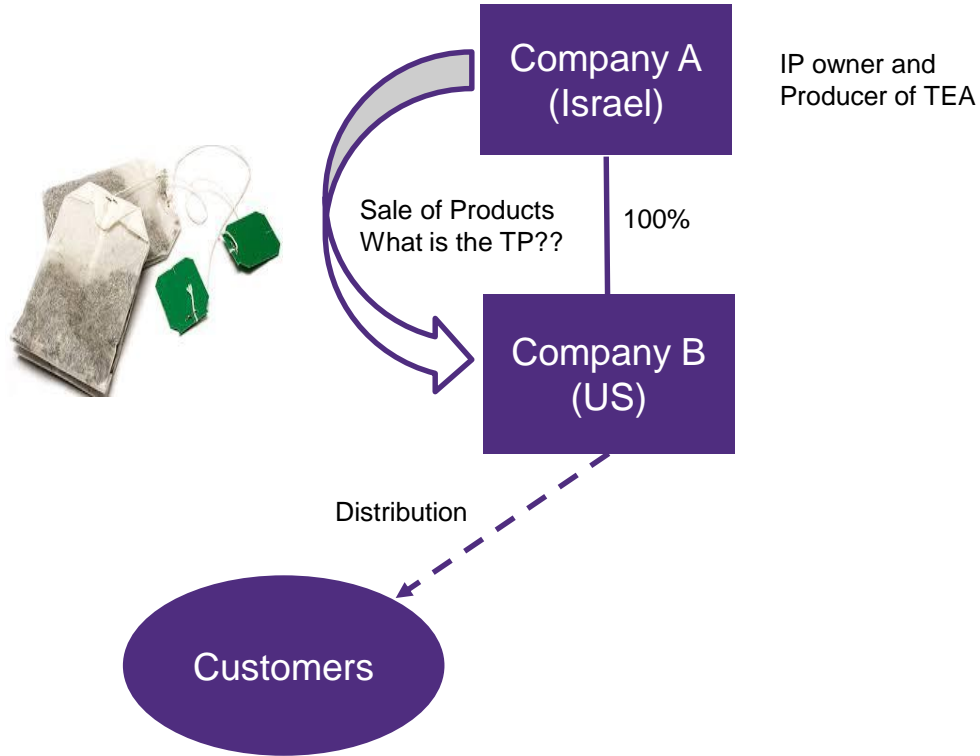
What is Transfer Pricing?

- Transfer Pricing (TP) deals with international transactions between related parties where “special relationship exists”;

Related Party Transactions can include;

- Services (marketing, R&D, business development, management fees)
 - intercompany financing i.e. interest on loans
 - Royalties for use of IP,
 - purchase/sale of Products,
 - mergers and acquisitions etc.
 - Business restructuring – a transfer of functions assets and risks can trigger a taxable event
- “Arm’s length principle” - related party transactions should represent prices/income that would have been generated under similar conditions by independent parties – i.e. Market Value

Arm's length principle?



Why is TP so important?

- Compliance with Domestic and Foreign Tax Law
- Tax Authorities around the world want their fair share of tax!
- Part of any good tax planning - illogical tax structures and creation of mixed IP
- Reduces exposure to adjustments by the tax authorities during tax assessments
- Reduces exposure to double taxation – unable to reclaim the expense in the other tax jurisdiction
- Reduces exposure to Penalties
- Damaged Reputation – Makes the headlines !!
- Lengthy TP audits and tax enquiries - expensive legal and accounting fees to defend TP practices.
- Criminal proceedings against individuals responsible for the transfer pricing implementation
- VAT / Customs / Withholding tax implications
- Tax Due Diligence – In transactions involving mergers and acquisitions if there is lack of reliable TP documentation or potentially large TP exposures so this may affect the outcome of the transaction
- Audit - if there is lack of proper TP documentation this could delay and affect the signing off of the audit as the auditor may need to provide for a large tax liability. In the US for example - FIN 48 exposure

Israeli TP Regulations

- Israeli TP Regulations were introduced in 2006 under article 85A of the Israeli Income Tax Ordinance and the Income Tax Regulations
- Very similar to OECD and US TP legislation
- In 2008, the Israeli Tax Authority published a circular with detailed TP guidelines and stating that TP documentation needs to be prepared
- Companies need to produce TP documentation within 60 days following a request from Tax Authorities
- Details of TP needs to be submitted in the tax return (Form 1385)
- General penalties can apply of up to 30%
- New Circulars issued by the ITA in recent years and new draft legislation
 - Clarifying Low Risk Distribution, Marketing and setting safe harbors on certain transactions
 - Business Restructurings and Royalties vs Sale of IP subject to capital Gain
 - Burden of Proof – emphasis on client to prepare sufficient TP documentation

OECD's Digital Taxation Deal

Background:

- OECD BEPS Action Plan One addresses the challenges of taxing the digital economy in today's world.
- The main problem/issue with the digital economy is that there is an absence of physical presence.
- Think of Companies like Facebook Amazon, Google, Netflix. Also online gambling and advertising companies.
- A significant number of online companies generate substantial revenues/profits of which Governments from around the world receive very little or no tax revenue.

Tax Deal:

- On 8th October 2021 – Deal agreed by 136 Countries including Israel.
- Likely implementation 2023.
- This will result in re-allocating more than USD 125 billion of profits from around 100 of the world's largest and most profitable MNE's ensuring a fair share of tax wherever profits are generated.
- This deal consists of two pillars.

Pillar two – Less TP but more general Tax

- Affects Companies with Group turnover of over 750 million Euros – same as CbCR reporting.
- Sets a minimum global tax rate of 15% setting a level playing field and putting a backstop on tax competition.
- Pillar two has less TP considerations than Pillar one. It will be interesting to see if there will be a cancellation or modification of law of encouragement of capital investment and reduction in tax incentives also for new tax residents making aliya in line with the minimum tax rate. The set up of the minimum global tax rate may encourage more companies to headquarter in Israel and not just for R&D cost plus centers. Companies should review their TP model and structure.

OECD's Digital Taxation Proposal (Cont.)

Pillar One – Less TP but more general Tax

- Affects approximately 100 of the worlds largest Companies with revenues of EUR 20 billion but this threshold is to be reduced to EUR 10 billion.
- Pillar One is based on TP principles and uses a profit split method once arm's length routine profits have been allocated.
- To illustrate this – an MNE Group such as Facebook would firstly compensate its affiliated companies in countries for routine functions such as marketing, distribution, R&D on lets say a cost plus basis. After this allocation there is now a balance of profit to be split between the Group. The current level of residual profit to be split is 25% of the residual profits. This would be split between the Group entities in countries where users and consumers are present (whether or not the company itself has a physical presence or not).

New Draft Bill

- In October 2020 – ITA publicized its proposal to amend Section 85A of the Income Tax Ordinance and its regulations.
- Grant Thornton anticipates that the expected date of implementation will be during 2022 relevant for FY 2021 tax reporting.
- The proposed legislation follows OECD's Base Erosion and Profit Shifting (BEPS) Action 13.
- Local File, Master File, and a Country-by-Country (CbC) report, will be required.
- TP documentation including a local file and master file needs to be prepared contemporaneously - prepared annually, at same time with the Israeli tax return. This replaces previous requirement of 60 days.
- Documentation will be much more detailed than in the past.
- CbCR - Taxpayers whose ultimate parent entity is a resident of Israel and is part of a Group that exceeds NIS 3 billion will be required to submit an online report within one year from the end of the tax year, that includes a comprehensive disclosure on all of the group's entities.
- It is anticipated that Israeli Companies, who are not the ultimate parent entity, and who are part of a Group that exceed NIS 3 billion will be required to make notification to the ITA as in other OECD countries.
- Anticipated new penalties for non-compliance.

Court Cases and Circulars

Sephira & Offek Ltd and Daniel Amram vs Jerusalem 3 Assessing Officer 16th August 2021:

- 1999 - Daniel Amram registered a trademark in France in while he was tax resident in France and at same year formed a French Company under the name Sephira SAS.
- 2003 - Daniel Amram made aliya and formed an Israeli Company Sephira & Offek Ltd (Sephira Israel) which provided R&D services and call center services to its related parties abroad based on a TP Study.
- 2011 – Sephira Israel reported its income from R&D services as Preferred Income under the encouragement law and paid a reduced income tax.
- July 2011 – Daniel Amram sold his rights in the trademark to Sephira Israel for EUR 8.4 million. At the time this was regarded as tax exempt for Daniel Amram.
- Following sale of trademark – Sephira Israel licensed the trademark to Sephira SAS for royalty income.
- Sephira Israel registered the trademark and amortized it using different rates throughout the years (5% - 7%) even though rate of goodwill is generally 10% under Israeli tax regulations. This expense was deducted against the royalty income.
- In addition Daniel Amram had a payable to Sephira Israel of NIS 5 million which was offset against Company payable to Daniel Amram post sale of trademark.

Court Cases and Circulars

Sephira & Offek Ltd and Daniel Amram vs Jerusalem 3 Assessing Officer 16th August 2021:

- The Israel Tax Authorities contended;
 - The Sale of trademark was artificial together with the amortization and royalty income at the level of the Company.
 - The profit level recorded by the Company for its R&D activity exceeds the industry profit level and therefore the excess profit should have been taxed as ordinary income subject to the standard corporate income tax rate.
- The Court ruled;
 - The sale was artificial and Daniel Amram took advantage of negative tax planning of tax benefits entitled to a new immigrant and no commercial reasons could be provided for such transaction.
 - The royalty income was earned by Amram and therefore subject to personal tax.
 - That the operating profit of Sephira Israel was above the interquartile range in the TP Study performed by the Company. And recognized that there was an incentive to shift profit from a higher tax regime in France to preferred income lower tax regime in Israel.
 - Regarding this excess profit, the ITA wanted to tax as ordinary income from the median result of the TP study but the court disagreed and suggested it should be excess of the highest interquartile range. This is based on Section 85A being applicable only in cases where the taxpayer records lower income than required.
- Conclusions ;
 - MNE's should maintain sufficient TP documentation and review such business restructurings and issues regarding sale of IP and transfer of assets risks and functions.
 - MNE's should recognize the use of TP documentation to determine excess income recorded beyond arm's length that should be subject to ordinary income and not preferred income such as R&D cost plus centers.
 - Individuals also subject to Transfer Pricing Regulations and examination into new immigrants and their restructuring for tax planning should be reviewed by professionals..

Court Cases and Circulars

Income Tax Circular No. 1/2021 – Payment to Parent Company for the Grant of its Stock options to employees of the foreign subsidiary (recharge agreements).

- This circular clarifies the position of the Israel Tax Authority for the tax treatment of the intercompany charge between the Employing Company and the Granting Company in respect of equity instruments granted (recharge agreements) when the expense was included as an expense/cost for purposes of Section 85A of the Kontera ruling
- The Kontera ruling – Cost of options granted should be included in the cost base for the purposes of Section 85A of the Income Tax Ordinance. This ruling didn't refer to the intercompany charge for equity instruments granted insofar as one exists between the employing company and the granting company.
- The circular considers what circumstances and conditions should the payment made by the employing company to the granting company be categorized as a dividend or reimbursement of payroll expenses.
- Important to note that one of the general conditions that the recharges will qualify as expenses and not a dividend, is that the entire expense was included as an expense in cost base for purposes of Section 85A of the Ordinance as per the Kontera ruling.

TP Department in Fahn Kanne

Services we offer to clients

- TP Planning as part of overall tax planning
- TP Compliance - Master File, Local File, Country-by-Country reporting
- Review of TP model in light of Corona and optimal tax structure according to arm's length
- Cross-border Engagements with GT network
- Represent Clients in tax disputes (diyunim)
- Pre-rulings or advance pricing agreement.
- Implementation of Transfer Pricing – internal controls, costings, allocation keys, invoicing etc.

Thanks!



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