Annual Tax Conference

Transfer Pricing

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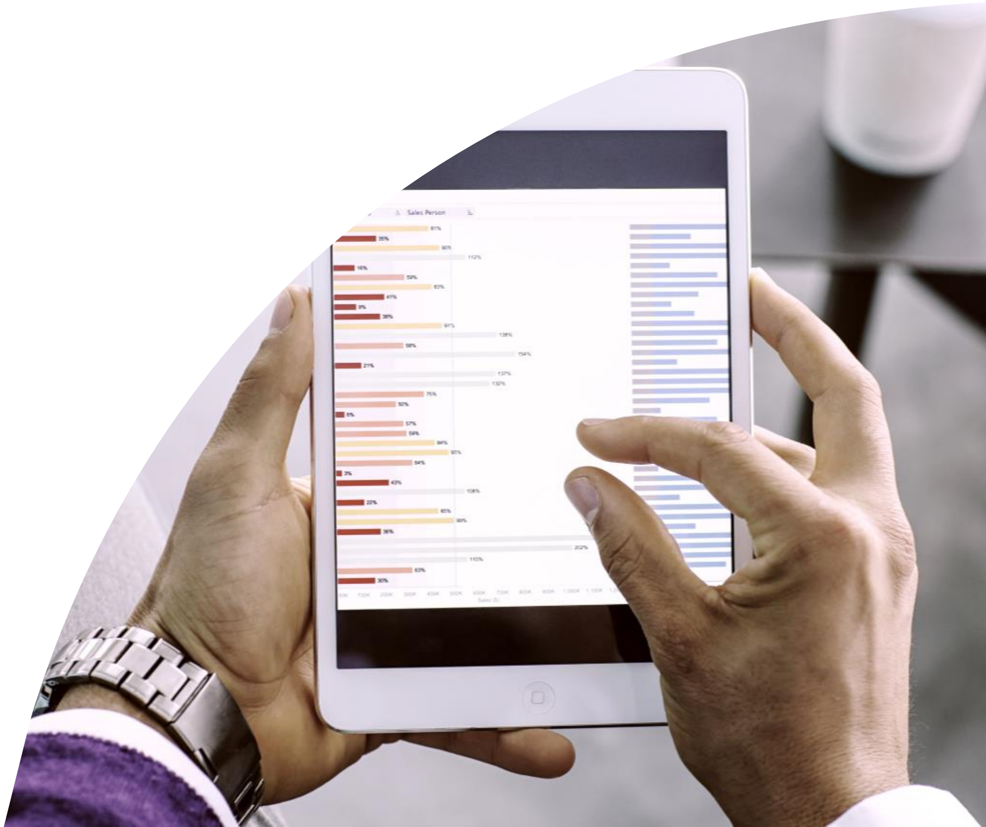
Fahn Kanne



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What is Transfer Pricing?

- Transfer Pricing (TP) deals with international transactions between related parties;
  - services, intercompany financing, royalties, purchase/sale of Products, mergers and acquisitions etc.

- “Arm’s length principle” - related party transactions should represent prices/income that would have been generated under similar conditions by independent parties.

- TP ensures that there is no reduction in taxable profits and that the correct taxes are being paid in the relevant countries

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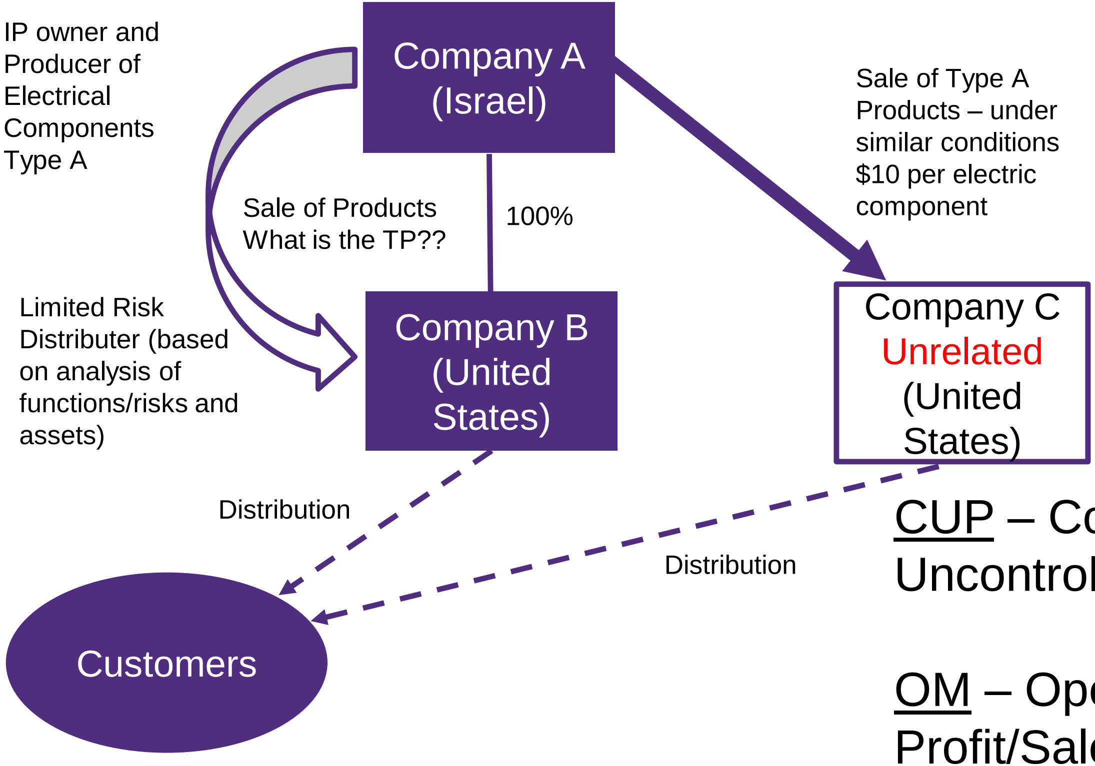
Arm's length principle?



<u>CUP</u> – Comparable Uncontrolled Price

<u>OM</u> – Operating Profit/Sales - <u>**benchmark**</u>

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TP in the Headlines

The Economist

Corporate taxation

Wake up and smell the coffee

Starbucks's tax troubles are a sign of things to come for multinationals

Dec 15th 2012 | NEW YORK | from the print edition

Mail Online

Microsoft avoids paying £159MILLION in corporation tax EVERY YEAR using Luxembourg tax loophole

Microsoft

Belgium introduces a 'fairness tax'

"Australian MP challenges Apple on Claims Of $5.5B in Costs, Resulting $40M in Tax"

amazon.com

"Amazon Vows to Dispute France's $252 Million Tax Adjustment Claim"

Mail

Tax avoidance is robbing Britain of £5BILLION a year: Spending watchdog warns taxman is struggling to control epidemic

- National Audit Office inquiry lays bare 'staggering' scale of tax avoidance
- 2,289 tax avoidance schemes disclosed to HMRC by experts in eight years
- HMRC probing 41,000 tax avoidance cases among small firms or individuals

By BECKY BARROW

The Telegraph Google

Google's £6billion Bermuda tax shelter

Web giant Google avoided £1billion in tax by using the island of Bermuda as a tax haven, official documents reveal, as David Cameron calls for a global crackdown on multinationals' tax arrangements.

"The big internet companies excel at routing their profits into tax havens." French government report on digital economy taxation

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TP Implications

If Companies shift profits and do not pay enough tax the following could apply;

- Tax Adjustments
- Penalties such as in the US – up to 40% penalty of tax adjustment
- Double taxation – cannot reclaim the expense in the other tax jurisdiction
- Damaged reputation
- 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

Other considerations;

- Tax Due Diligence – In transactions involving mergers and acquisitions one of the areas of a tax due diligence that is performed is that of the TP and if there is lack of reliable TP documentation or non-disclosures or incorrect TP policy with potentially large tax exposures so this will 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. As accountants and professional advisers – it is our duty to inform our clients of the TP exposures and ensure that all relevant documentation has been prepared to ensure a smooth sign-off of the audit.

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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% of any tax adjustment plus the usual linkages and interest. False declaration on Form 1385 may expose the signing person to criminal charges.

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1385

Form 1385

הצהרה על עסקאות בינלאומיות

כמשמעותן בסעיף 85א לפקודת מס הכנסה

נספח לדוח השנתי לשנת המס ____________

פרטים לגבי עסקאות עם צדדים קשורים בחו"ל

מספר העסקה(1) ____________	
העסקה היא חד פעמית ☐ כן ☐ לא	
תיאור העסקה(2) (פירוט סוג הנכס או השירות ותחום הפעילות)	
פרטי הצד הקשור לעסקה(3)	
מקום מושב של הצד הקשור	
סך מחיר העסקה(4)	

Description of transaction – services/royalties/interest?

Details of related party/ies

Location

Amount of transaction and what TP method was chosen i.e. cost plus or profit split

הנני מצהיר/ה כי העסקה עם הצדדים הקשורים בחו"ל נערכה בהתאם לתנאי שוק

כפי שהוגדרו בסעיף 85א לפקודת מס הכנסה והתקנות הנילוות.

Declaration by signing officer that the intercompany transactions are conducted in accordance with the arm's length principle.

שם	תאריך	מספר זהות/ח.פ	חתימה

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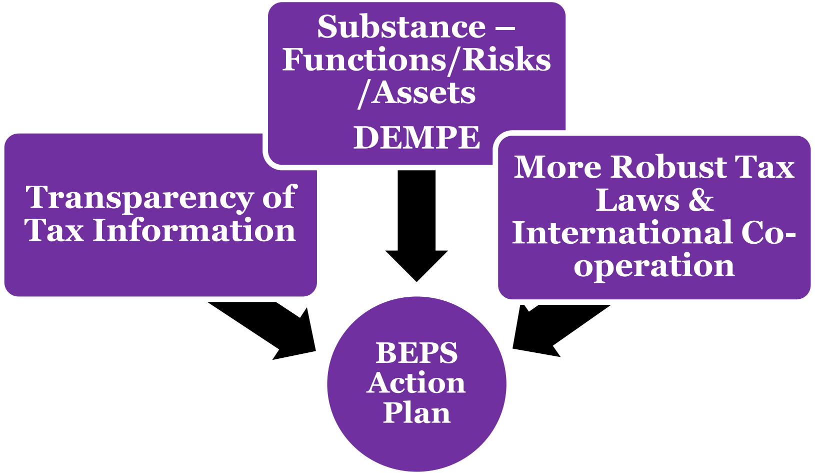
OECD and BEPS

- In an attempt to prevent multinational corporations from profit shifting and undertaking aggressive tax avoidance, the OECD members and G20 leaders got together in June 2012 and designed a 15 point Action plan to tackle **B**ase **E**rosion and **P**rofit **S**hifting (BEPS)
- In todays tax climate Transfer Pricing is probably the most important tax exposure facing MNE’s
- The project is the largest overhaul of the global tax regime we have seen in decades
- Currently 109 countries have signed up to the BEPS package including Israel representing approximately 95% of the worlds GDP. All Countries expect their slice of tax and BEPS enables them to receive it
- OECD estimates that $250 billion revenues are lost annually as a result of BEPS ensuring that TP remains a high priority for Tax Authorities!



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BEPS Action Plan – Breakdown of BEPS Action Plans

Action 1 Address the challenges of the digital economy	**Action 2** Neutralize the effect of hybrid mismatch arrangements	**Action 3** Strengthen CFC rules	**Action 4** Limit base erosion via interest deductions and other financial payments	**Action 5** Counter harmful tax practices more effectively, taking into account transparency and substance
Action 6 Prevent treaty abuse	**Action 7** Prevent the artificial avoidance of PE status	**Action 8** Assuring that TP outcomes are in line with value creation Intangibles	**Action 9** Assuring that TP outcomes are in line with value creation (Risks and Capital)	**Action 10** Assuring that TP outcomes are in line with value creation (Other high-risk transactions)
Action 11 Establish methodologies to collect and analyze data on BEPS and the actions to address it	**Action 12** Require taxpayers to disclose their aggressive tax planning arrangements	**Action 13** Re-examine transfer pricing documentation	**Action 14** Make dispute resolution mechanisms more effective	**Action 15** Develop a multilateral instrument

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OECD BEPS Actions 8-10 “Aligning Transfer Pricing Outcomes with Value Creation”

- Helps to align profits with the economic activities that generate them and identifying key functions/risks/assets of each entity
- At large deals with intangibles and difficult intangibles to value
- For transactions that involve use or transfer of intangible assets OECD Companies need to determine which entities are involved in the “DEMPE” functions and a DEMPE analysis needs to be conducted
- According to BEPS, Companies that have legal and contractual ownership of intangibles but don’t perform any functions/assets/risks can no longer automatically record the profits. Need to look at what all the Group entities are contributing. You cant simply register the IP in a low-tax country or treaty shop and record most of the profits if you cant show substance - functions/risks/assets being employed
- Gone are the days of cost plus?? OECD BEPS challenges the utilization of cost plus models. R&D? Sales and marketing? A move to profit splits…….

Development
Enhancement
Maintenance
Protection
Exploitation

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A Three-tiered Approach to Transfer Pricing Documentation – BEPS ACTION 13

Effective globally in tax year 2016

Local File

Master File

Country by Country

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OECD and BEPS Documentation

- **Master File**
  - Typically prepared by the Parent Company of the Group and submitted annually in each tax jurisdiction together with local file
  - Provides general information on the global operations of the entity
  - Identifies the intercompany transactions and TP policies
  - Overview of industry, key products, drivers of profit, its intangibles and DEMPE analysis functions/risks and assets and how the group is financed and intercompany loans
  - Financial and tax positions - including consolidated financial statements and tax rulings.
- **Local File**
  - The local file will be submitted annually in local tax authority together with the Master File
  - Will identify the intercompany transactions for the local entity and present economic analysis and the benchmark results and choice of TP methodology
  - The local file will include more detailed functional/asset and risk analysis than the Master File
  - Must include a description of the management structure of the local entity, a local organization chart, and a description of the individuals to whom local management reports and the country(ies) in which such individuals maintain their principal offices – If senior management are located in different entities, so this will affect the TP
- **Country By Country Report**
  - Additional report to be submitted in ultimate Parent's tax jurisdiction – relevant for Companies with turnover of more than 750 million Euros (3.4 billion NIS). Will be shared by tax authorities by a shared exchange platform

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A model template for the Country-by-Country Report

Table 1. Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned:										
Tax Jurisdiction	Revenues			Profit (Loss) Before Income Tax	Income Tax Paid (on cash basis)	Income Tax Accrued – Current Year	Stated capital	Accumulated earnings	Number of Employees	Tangible Assets other than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							

GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING © OECD 2014

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Table 2. List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction

Name of the MNE group: Fiscal year concerned:															
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organisation or incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)												
			Research and Development	Holding or Managing intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing or Distribution	Administrative, Management or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments	Dormant	Other[2]
	1.														
	2.														
	3.														
	1.														
	2.														
	3.														

GUIDANCE ON TRANSFER PRICING DOCUMENTATION AND COUNTRY-BY-COUNTRY REPORTING © OECD 2014

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New Proposed Israeli Regulations

- As a result of the BEPS new Israeli legislation has been drafted and is awaiting approval by the Knesset
- GT Israel and five other top accounting firms were invited to a meeting with Moshe Asher to share our thoughts on the new proposed Israeli Legislation
- Adding New Sections to 85A to establish new documentation and reporting requirements.
- New rules are expected to provide Israeli Government new tools/resources to target profit shifting from Israel to lower tax jurisdictions.
- Expect tighter rules around documentation and reporting of global TP mechanisms
- Increased size of Transfer Pricing department in Israeli Tax authorities to handle all the changes and increased tax enquiries (diyunim) expected.

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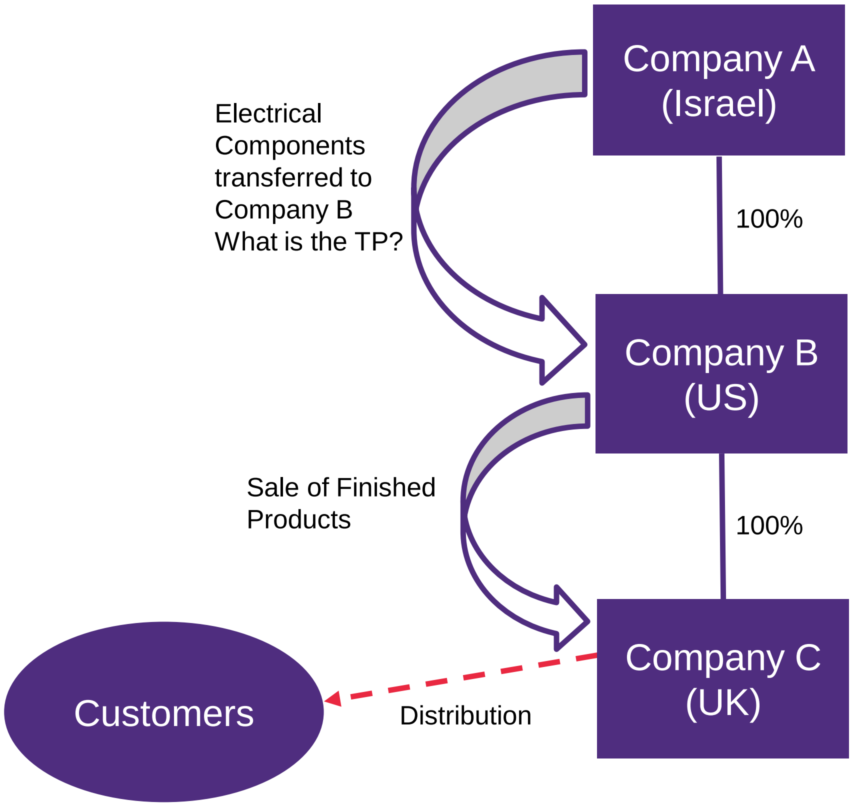
Profit Split analysis



Company A is Designer and Manufacturer of Electrical Components – innovative technological design of processes and the component

Company B is Designer and Manufacturer of rest of the Electrical Components – innovative technological design of processes and the component

Company C is a Limited Risk Distributer – TNMM OM model (operating profit divided by sales)
IQ range of 2% - 4% with median of 3%

Company C	USD
Revenues	100,000
COGS TP Plug In ?	(70,000)
Gross Profit	30,000
Operating Expenses	(27,000)
Operating Profit 3%	3,000

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Residual Profit Split based on R&D

Company A
10/15 = 2/3

2/3 * 3,000 = 2,000

Company B
5/15 = 1/3

1/3 * 3,000 = 1,000

	Company A	Company B	
Revenues	40,000	70,000	
Purchases	(5,000)	(40,000)	
Manufacturing Costs	(10,000) 800 cost plus 8%	(15,000) 1,200 cost plus 8%	2,000 manufacturing profit
Gross Profits	25,000	15,000	
R&D	(10,000)	(5,000)	15,000
Operating Costs	(10,000)	(10,000)	
Operating Profit	5,000	0	5,000
Residual Profit (Operating profit minus manufacturing profit)			5,000 – 2,000 = **3,000 RP**
New OP Profit	800 + 2,000 = 2,800	1,200 + 1,000 = 2,200	

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How Fahn Kanne can help

- TP should be part of any tax planning and business consideration from an early stage
- Companies should review their TP policy on an ongoing basis – including review of documentation and intercompany agreements
- Update existing work to be compliant with new legislation both for OECD BEPS and also on a local level throughout the Group. Prepare early!!
- We work with our member firm in over 130 countries providing total TP compliance package and can assist with Masterfile, Local File and Country by Country Reporting. We also consult with our local members to understand the local Regulations and reporting requirements
- We can approach the Tax Authorities for a pre-ruling or advance pricing agreement.
- Represent Companies in front of the tax authorities

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