

# 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
- BEPS and OECD and other Global TP Updates including EU Mandatory Disclosure Regime
- Closer look at OECD Digital Taxation Proposal for online businesses

## 2. The New updated 1385 form (part of Tax Return)

## 3. Recent ITA Circulars dealing with Transfer Pricing

- Distribution, Marketing and Low Value added Services – September 2018
- Business Restructuring – November 2019 (refer to Gteko case and Broadcom case)
- Burden of Proof – June 2020 (first ITA circular released since Corona)

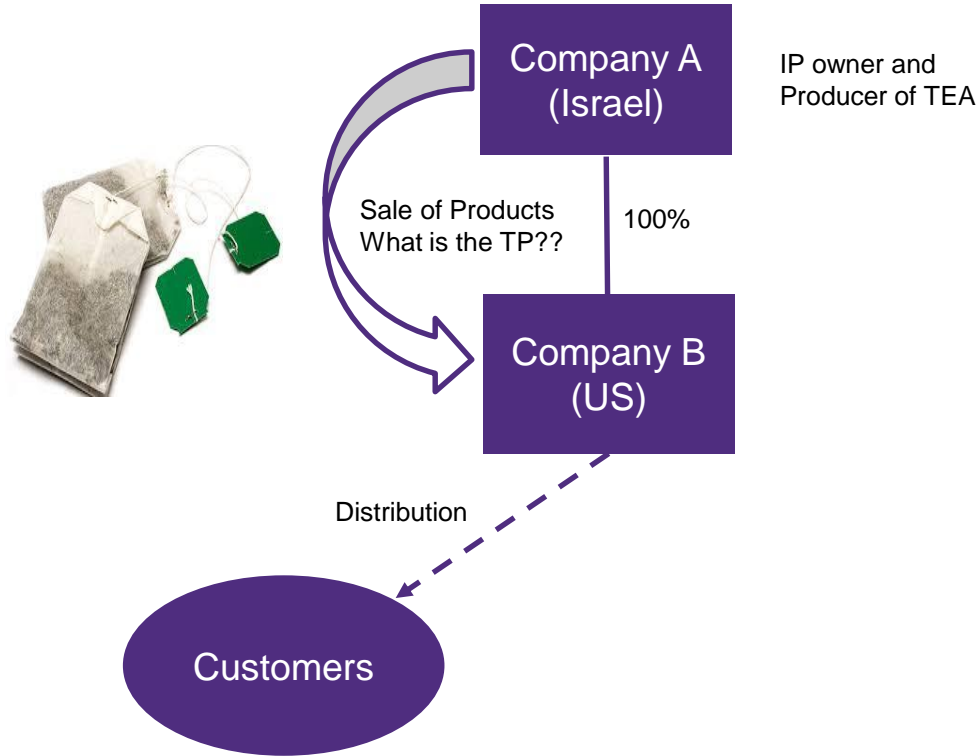
## 4. Draft Bill to significantly amend Transfer Pricing Rules and Regulations

- 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

# What is Transfer Pricing?

- Transfer Pricing (TP) deals with international transactions between related parties where “special relationship exists”;
  - Services (marketing, R&D, business development, management fees)
  - intercompany financing i.e. interest on loans
  - 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

# Arm's length principle?



# Why TP?

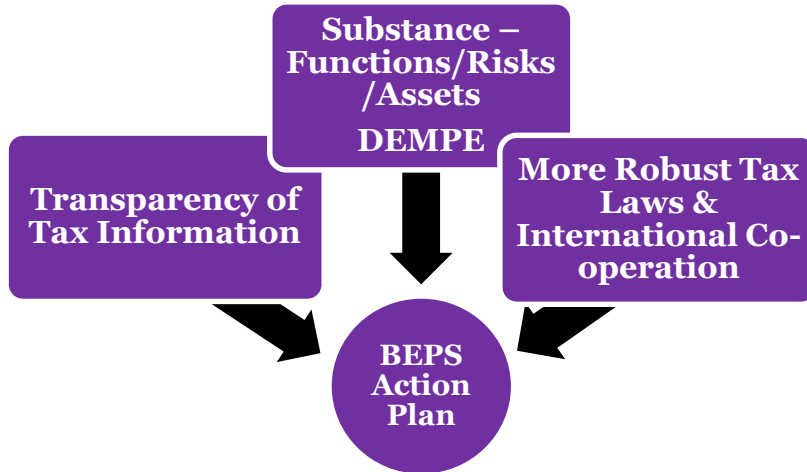
- Tax Authorities around the world want their fair share of tax!
  - Part of any good tax planning - illogical tax structures and creation of mixed IP
  - Tax Compliance and disclosures
  - Reduces exposure to adjustments by the tax authorities during tax assessments
  - Reduces exposure to double taxation – 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 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 and new legislation ... we will look at these more closely soon

# 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 **Base Erosion and Profit Shifting (BEPS)**
- The project is the largest overhaul of the global tax regime we have seen in decades
- Currently 135 countries have signed up to the BEPS package including Israel representing approximately 95% of the worlds GDP.
- OECD estimates that \$250 billion revenues are lost annually as a result of BEPS ensuring that TP remains a high priority for Tax Authorities!



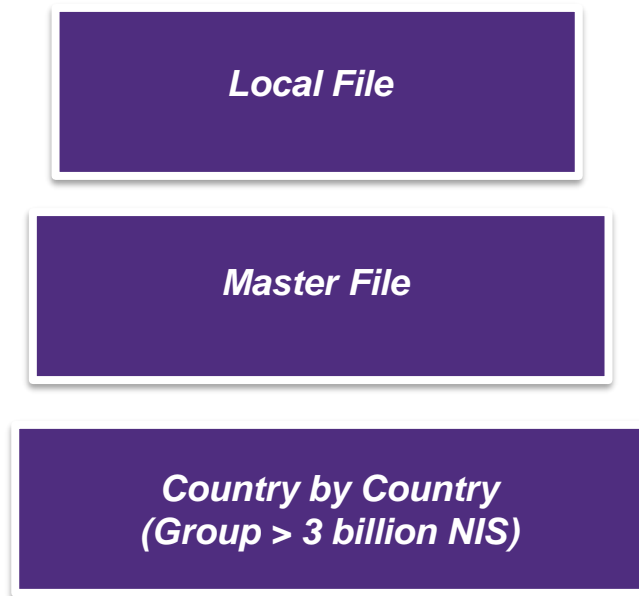
# BEPS Action Plan – Breakdown of BEPS Action Plans

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



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

Effective globally from tax year 2016



# OECD's Digital Taxation Proposal

## Digital Economy:

- OECD BEPS Action Plan One addresses the challenges of taxing the digital economy.
- The main problem/issue with the digital economy is that there is an absence of physical presence.
- A significant number of online companies generate substantial revenues/profits of which Governments from around the world receive very little or no tax revenue.
- The digital economy includes both digital businesses and consumer facing business.
  - ❖ *Digital businesses include social media and search engine corporations such as Facebook as well as online gambling and online advertising companies.*
  - ❖ *Consumer facing business would include online clothing, food and beverage businesses as well as electronic and household appliances.*
- The exceptions consist of those businesses selling semi finished goods for the purposes of manufacturing, extractive industries (e.g. entities that are engaged in the oil/gas extraction), financial services (such as banks/insurance), and transportation companies, including airlines.

## Tax Updates:

- On 31 January 2020, G20/the OECD released a statement on the progress in addressing the tax challenges arisen from the digitalization of the economy.
- The statement confirms the intent to finalize the unified approach to profit allocation in the digital economy (Pillar 1) by the end of 2020.
- In addition, a significant progress was noted in relation to the approach to the taxation of base erosion payments (Pillar 2).
- This is a significant process, this is not likely to be applied before FY 2023.

# OECD's Digital Taxation Proposal (Cont.)

## Tax Updates:

### Pillar One:

- Consists of a unified approach to profit allocation - three tier framework that provides three parts in respect to a profit allocation mechanism:
  - **Amount A:**
    - Profit Split by way of share of residual profit after Amounts B and C paid.
    - Calculated based on a formulae (most likely by way of an allocation key of revenues). This is likely to be based on certain thresholds and fixed percentages.
  - **Amount B:**
    - Remuneration in respect to routine distribution and marketing functions.
    - This is likely to be up to a fixed percentage
  - **Amount C:**
    - This relates to remuneration for extra functions performed that exceed routine marketing and distribution functions that are based on existing transfer pricing rules and effective dispute resolutions.
    - For example if an entity was engaged in the specific development of an application.

### Pillar Two

- The first part of Pillar two is the "Income Inclusion Rule)". This relates to the top-up taxation of base erosion payment. I.E. Where profits in a foreign branch or controlled foreign company are taxed at a rate below the minimum rate
- The minimum rate has been set at 12.5% but could be subject to change.
- The rationale behind this is that global tax authorities will have the taxing right over the profit of a foreign branch or a foreign controlled company, if that profit was taxed at an effective rate below the minimum rate.
- The second part of pillar two refers to the tax of base erosion payments (i.e. instances whereby payments to related parties are below the minimum rate (such as for intragroup services), a withholding tax will be introduced.

# EU Mandatory Disclosure Regime

- A new EU Directive that stems from OECD BEPS Action 12, imposes mandatory reporting of potentially aggressive tax planning arrangements involving EU Member States.
- After 1 July 2020, intermediaries and taxpayers will be required to report within 30 days of a triggering event in respect of any tax arrangements to the relevant tax authorities.
- The new mandatory disclosure regime is very broadly drafted and could capture various ordinary commercial transactions.
- The **reporting obligation** falls initially on the applicable EU based “intermediary” (banks, accounting firms, law firms and other service providers) involved in the arrangement. However, where there is no EU intermediary, or where legal and professional privilege applies, the reporting obligation falls on the “taxpayer.”
- Information about the transaction, the ME Participant, the values and associated parties will need to be disclosed to EU tax authorities.
- **Why is it important to Israeli Companies?** If Israeli Companies operate through subsidiaries, or foreign branches within the EU, these Companies could have a reporting obligation, and therefore, TP plays a significant role in reducing potentially aggressive tax planning and reducing the reporting obligations.
- Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom have already implemented the regime.

# Form 1385 – New

## Section C: Details of the international transaction with Related Parties abroad:

- Description of the transaction –income or expense and the area of activity, type of asset or service.
- Transfer Pricing method utilized in respect to the transaction – This is now separated from price of the transaction allowing greater scrutiny by the ITA.
- Profitability Rate - This is a significant change.
- Transaction Amount: Requirement to detail the income or expenses as they appear in the financial statements of the taxpayer.

## Section D: Details in respect to the pricing of the International Transaction (yes or no answer):

- If the transaction is a onetime transaction.
- If the transaction is considered a low value transaction that it fulfills the criteria specified in the tax circular 12/2008 and in accordance with the provisions thereof.
- If the transaction is in respect to the provision of marketing services it fulfills the criteria specified in the tax circular 12/2008 and in accordance with the provisions thereof.
- If the transaction is in respect to the provision of distribution activities it fulfills the criteria specified in the tax circular 12/2008 and in accordance with the provisions thereof.

## Section E: Declaration – Updated details:

- Requirement that the individual responsible for signing the form needs to detail their position within the Company. E.g. Chief Financial Officer/Financial Controller
- Updated declaration statement that all the details in the form are correct, complete and accurate.
- This is a new requirement and was previously not requested on the old 1385 Form.



## הצהרה על עסקה בין-לאומית כמשמעותה בסעיף 85א לפקודת מס הכנסה והתקנות<sup>(1)</sup> מכוחו נספח לדוח השנתי לשנת המס

**א. פרטי הנישום**

מספר טלפון	מספר תיק ניכיים	מספר תיק במס בנסה	שם הנישום
/			
משרד פקיד השומה ניכיים	משרד פקיד השומה	כתובת העסק	

**ב. פרטי הצד הקשור**

שם הצד הקשור	מספר זהויה לצדכי מס בחו"ל (TIN)	כתובת

**ג. פרטי העסקה הבין-לאומית עם צדדים קשורים בחו"ל - יש למלא את כל הסעיפים**

מספר העסקה <sup>(2)</sup>	
תיאור העסקה <sup>(3)</sup>	
השיטה שנקטה <sup>(4)</sup>	
שיעור הרווחיות <sup>(5)</sup>	
סכום העסקה <sup>(6)</sup>	

**ד. מחירי העסקה הבין-לאומית נקבע בהסתמך על אחד מאלה:**

העסקה המדווחת היא עסקה חד פעמית בהתאם לתקנה 4 לתקנות	כן <input type="checkbox"/> לא <input type="checkbox"/>
העסקה מסוג שירותים המוסיפים ערך נמוך, עומדת בתנאים המפורטים בחוזר 12/2018 ומדווחת בהתאם לקבוע בו	כן <input type="checkbox"/> לא <input type="checkbox"/>
העסקה מסוג שירותי שיווק, עומדת בתנאים המפורטים בחוזר 12/2018 ומדווחת בהתאם לקבוע בו	כן <input type="checkbox"/> לא <input type="checkbox"/>
העסקה מסוג שירותי הפצה, עומדת בתנאים המפורטים בחוזר 12/2018 ומדווחת בהתאם לקבוע בו	כן <input type="checkbox"/> לא <input type="checkbox"/>

**ה. הצהרה**

הנני מצהיר/ה כי העסקה עם הצדדים הקשורים בחו"ל המפורטים בטופס זה נערכה בהתאם לתנאי השוק כפי שהוגדרו בסעיף 85א לפקודת מס הכנסה והתקנות מכוחו וכי כל הפרטים בטופס זה נכונים, שלמים ומדויקים.

תאריך \_\_\_\_\_ שם \_\_\_\_\_ תפקיד \_\_\_\_\_ חתימה \_\_\_\_\_

# Recent ITA Circulars dealing with Transfer Pricing

## 1. Circulars 11&12/2018 – LRD vs S&M vs Low Value - Released September 2018

- **Distribution Companies (LRD)** - safe harbor of operating margin of 3% - 4%. Still need to be backed up by TP study analyzing FAR that the entity meets the definition of a LRD. Or could be analyzed as a profit split.
- **Sales and marketing Companies** – safe harbor of cost plus of 10%-12%. Still need to be backed up by TP study analyzing FAR. Or could be analyzed as a profit split.
- **Low Value Added Services** – such as admin (excludes R&D or BD for example) – safe harbor of cost plus 5%. Still need to be backed up by TP study analyzing FAR.

## 2. Circular 15/2018 – Business Restructuring Released November 2018

- Recent merger acquisition / business restructuring? - Shifting of the functions/assets and/or risks?
- Change from fully fledged developer or manufacturer to cost plus?
- ITA Circular evaluates what will be the ITA position if a business restructure has triggered a sale of IP and large capital gain.
- Circular compares sales of IP and grant of royalty (royalty payments especially if large accumulated losses may never see tax paid in Israel).
- Examples of High Profile Court Cases – Gteko and Broadcom (following slide)

# Recent ITA Circulars dealing with Transfer Pricing

## Gteko/Microsoft Case – In favor of ITA

- An Israeli district court ruled in June 2017, that when an Israeli Company owning IP is acquired and shortly thereafter their employees and assets are transferred to a related party, and FAR (functions assets and risks) are transferred the transfer should be viewed as a sale of entire business activity and value of IP should be broadly defined and be derived from the share acquisition price for tax services.
- As a result, the judge ruled that the IP transaction, should be valued at a value similar to the share transaction and the value cannot evaporate and should be taxed accordingly. This was a significant landmark case in Israel. Shares were originally acquired for \$90 million, then the transfer to Microsoft was transacted at \$26 million. Court judged the value should have been around \$90 million.
- The ITA Circular references this case.

## Broadcom Case – Against ITA

- An Israeli district court ruled in November 2019, in favor of Broadcom and against the ITA in connection with the arguments asserted by ITA that as a result of change in a business model, post-acquisition, IP was transferred from Israel to Cayman.
- Some of the main differences from Gteko case was that Broadcom retained old clients, revenues grew, the contractual terms of agreement, employees were not transferred etc.

- ❖ **ANY CHANGE OR PROPOSED IN STRCUTURE/TP METHOD etc. SHOULD BE EVALUATED.**
- ❖ **COMPANY CANNOT SIMPLY SWITCH FROM FULLY FLEDGED DEVELOPER OR MANUFACTURER TO COST PLUS SERVICE PROVIDER OR SHIFT EMPLOYEES OR FUNCTIONS AND RISKS**
- ❖ **CONSDIER PRE-RULING and get certainty on transaction and loss utilization.**

# Recent ITA Circulars dealing with Transfer Pricing

## 3. Circular 1/2020 – Burden of Proof Released 2 June 2020

- First Circular in 2020 and the first one released since Corona.
- This circular highlights the importance of compliance of transfer pricing regulations and demonstrates that transfer pricing is high on the agenda for tax audits initiated by the ITA.
- Grant Thornton expects an increase in transfer pricing audits as a result of this new circular.
- The new circular replaces Section 2.5 of the 2008 circular which generally determined that once transfer pricing documentation was submitted to the ITA, the burden of proof would be accepted and borne by the assessing officer.
- This new circular clarifies the ITA position with respect to meeting the burden of proof and the evidence and type of documentation submitted upon request by the Israel Tax Authorities to comply with Section 85A of the Israel Tax Ordinance.
- Mere submission of transfer pricing documentation is not sufficient and that if the taxpayer fails to provide sufficient evidence of proof of certain items, then the transfer pricing documentation can be deemed to be non-compliant and incomplete. In such a case, the taxpayer would be treated as if it has failed to submit transfer pricing documentation and the burden of proof would not transfer to the ITA.
- The circular also deals with the broad power that the Tax Assessing officer now has to reject a transfer pricing study and undertake an assessment based on his/her “best adjustment,” and “experience” without the need to prepare/present an alternative economic study.
- The circular allows room for the ITA to self-determine whether transfer pricing documentation is incomplete or not compliant and raise “best judgement” assessments.
- The new circular can be interpreted as controversial and contradicts widely generally accepted transfer pricing practices as most OECD member countries place the burden of proof on the taxpayer.



# 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 2021 relevant for FY 2020 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.

# 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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