Transfer Pricing 2021

Contributing editors
Wendy Abkin, Barton WS Bassett, Sanford W Stark and Drew A Cummings

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Getting The Deal Through

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Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development manager
Adam Sargent
adam.sargent@gettingthedealthrough.com

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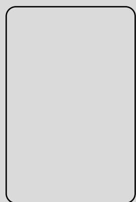

Transfer Pricing
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Morgan, Lewis & Bockius LLP

Lexology Getting The Deal Through is delighted to publish the seventh edition of *Transfer Pricing*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Canada, Israel and Japan.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Wendy Abkin, Barton WS Bassett, Sanford W Stark and Drew A Cummings of Morgan, Lewis & Bockius LLP, for their continued assistance with this volume.

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Israel

Eyal Bar-Zvi
Herzog Fox & Neeman

OVERVIEW

Principal legislation

1 | Identify the principal transfer pricing legislation.

Israel's transfer pricing regime is regulated under the transfer pricing regulations (the TP regulations), which are provided under section 85A of the Tax Ordinance, effective as of 29 November 2006. Section 85A introduces the arm's-length principle by asserting that an international transaction between 'parties with special relationships' should be reported to the tax assessment officer and be taxed in line with the appropriate market price.

Guidance regarding transfer pricing is provided in several tax circulars issued by the Israel Tax Authority (ITA). The ITA publishes circulars on transfer pricing and the interpretation of the TP Regulations.

Enforcement agency

2 | Which central government agency has primary responsibility for enforcing the transfer pricing rules?

The ITA.

OECD guidelines

3 | What is the role of the OECD Transfer Pricing Guidelines?

In general, the TP Regulations adhere to the arm's-length principle and incorporate the approach taken in the OECD Guidelines as well as that taken in section 482 of the US Internal Revenue Code towards determination of the correct analysis methods for examining an international transaction between related parties. Certain tax circulars offer a 'safe harbour' mechanism with specific margins.

Covered transactions

4 | To what types of transactions do the transfer pricing rules apply?

The scope of transfer pricing regulations in Israel is limited to cross-border transactions in which a special relationship exists between the parties to the transaction (ie, related parties) and covers all types of transactions, including: services (eg, research and development, manufacturing and marketing); distribution; the use or transfer of intangible assets (eg, know-how, patents, trade names or trademarks); and financing transactions (eg, loans, capital notes, guarantees and captive insurance).

The term 'special relationship' includes the association between an individual (including an entity) and that individual's relatives, the control of one party to the transaction over the other or the control of one individual over the other parties to the transaction, whether directly or indirectly, individually or jointly with other individuals. 'Control' means holding, directly or indirectly, 50 per cent or more of one of the indicators of control. Nonetheless, the ITA can often perform a qualitative test for the above threshold and examine a transaction even if the threshold itself is not met.

Arm's-length principle

5 | Do the relevant transfer pricing rules adhere to the arm's-length principle?

The TP Regulations adhere to the arm's-length principle and require that cross-border transactions concluded between related parties be priced at market prices.

Base erosion and profit shifting

6 | How has the OECD's project on base erosion and profit shifting (BEPS) affected the applicable transfer pricing rules?

The adoption of post-BEPS measures has been formalised in part in Israel, including guidance concerning business restructuring (Tax Circular 15/2018), low value-adding services (Circular 12/2018 regarding safe harbours) and measures related to digital economy (Tax Circular 4/2016). Other post-BEPS measures are under the consideration of the ITA, such as the DEMPE (development, enhancement, maintenance, protection and exploitation of intangibles) principles and principles on hard-to-value intangibles.

In addition, proposed legislation on the adoption of new transfer pricing documentation provisions in respect of BEPS Action 13 regarding the preparation of master files and country-by-country reports has passed the first reading (out of three) in the Israeli parliament. The applicable effective date of the proposed legislation has not yet been determined.

The ITA places great emphasis on business or economic substance when analysing value chains and transactions involving the transfer or use of intangible properties. This means that functions contributing to the creation of value, as well as where people are located, constitute important criteria when determining the appropriate attribution of profits among group members in multinationals. Consequently, there has been an increase in challenges by the ITA of cost-plus models and recharacterisation as profit splits, especially in cases of research and development services, as well as the deeming of marketing services as distribution activity. In other cases, the ITA has retroactively applied different methods from those used by the taxpayer, shifting between the comparable uncontrolled price and the transactional net margin methods, in cases where profit split was not applicable. Furthermore, the ITA is implementing a people-orientated analysis when conducting tax audits and, therefore, in certain cases, can determine management services as being a non-routine activity for the purposes of profit splits.

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PRICING METHODS

Accepted methods

7 What transfer pricing methods are acceptable? What are the pros and cons of each method?

The transfer pricing regulations (the TP Regulations) incorporate both the OECD Guidelines and the approach of section 482 of the US Internal Revenue Code towards the determination of the correct analysis methods for examining an international transaction between related parties, which include the following methods: the comparable uncontrolled price or transaction (CUP/CUT) method, the resale price method (RPM), the cost-plus method, the transactional net margin method (TNMM) and the profit split method. As such, the regulations require that the arm's-length result of a controlled transaction be determined under the method that, given the facts and circumstances, provides the most reliable measure of an arm's-length result, where there is a preference for transactional transfer pricing methods over profit-based transfer pricing methods.

Financing transactions

The TP Regulations do not provide specific guidelines for evaluating the arm's-length nature of intercompany financing transactions and, thus, follow a broader transfer pricing approach provided under the OECD Guidelines and section 482 of the US Internal Revenue Code.

Specifically, for intercompany loans, the evaluation of the arm's-length nature is carried out by establishing an arm's-length interest rate based on those applied in comparable third-party transactions. According to the OECD Guidelines, the transfer pricing methodology usually used when setting arm's-length interest rates is the CUP method, applying internal or external CUP analysis. The approach preferred by the Israel Tax Authority (ITA) is the external CUP method, which is a market valuation method as it relies on market yields of publicly traded corporate bonds that are comparable to the assessed intercompany loan in terms of credit-rating and loan terms when establishing the arm's-length interest rate.

Services transactions

The common method used in connection with services transactions is the TNMM, employing the net cost-plus ratio. With regard to services that fall under the definition of low value-adding (LVA) services, taxpayers can apply the safe harbour promulgated under Tax Circular 12/2018, prescribing a markup of 5 per cent.

A less common method is the cost-plus method, which compares gross margins of controlled and uncontrolled transactions. The cost-plus method is most often used to assess the markup earned by a service-providing entity that engages with related parties.

The cost-plus method applies where internal data is available in which a service renderer provides the same or similar services to both controlled and uncontrolled parties and where it provides detailed information concerning comparable transactional costs. In practice, this method is usually not applicable for evaluating the arm's-length nature of intragroup services, mainly because external data (ie, transactions between two third parties) found on public databases cannot be used reliably when applying this method.

Intangible property transactions

When pricing a transaction involving the right to exploit or the transfer of intangible assets (such as know-how, proprietary technology, patents, trade names or trademarks and the unique business model), the most common transfer pricing methodology implemented is the CUP/CUT method. This method uses external data concerning comparable agreements entered into between independent parties (or, when available, internal data provided by the taxpayer regarding its comparable uncontrolled transactions with third parties) for comparing the compensation terms stipulated in those agreements and, accordingly, establishing a royalty benchmark.

The process of evaluating arm's-length pricing for the transfer or exploitation of hard-to-value intangibles (HTVI) is more complex and requires the valuation of the expected return derived from intangible assets at their present value. This ex ante pricing is based on the assessment of the taxpayer regarding the expected return. As such, it will most certainly deviate from the actual return of ex post outcomes.

Recently, the ITA has demonstrated an implementation of the HTVI principles published by the OECD, in which it concurred with ex ante assumptions as the ex post result could not have been anticipated by the (related) parties to the transaction under review.

Cost-sharing

8 Are cost-sharing arrangements permitted? Describe the acceptable cost-sharing pricing methods.

Cost-sharing arrangements are not common in Israel, and there is no specific guidance in this respect. Nevertheless, there is no prohibition on applying them to establish the relationship and obligations of joint ventures. Usually in Israel, cross-licensing agreements, along with services agreements, are used to establish the responsibilities and rights of the parties to a joint venture.

Best method

9 What are the rules for selecting a transfer pricing method?

According to the TP Regulations, the preferred method is the CUP/CUT method because it can produce the most accurate and reliable arm's-length results. When the CUP/CUT method cannot be used, then one of the following methods should be employed:

- the RPM;
- the cost-plus method;
- the profit split methods (comparable or residual); or
- TNMM (similar to the comparable profits method (CPM) in section 482 of the US Internal Revenue Code).

If none of the above methods can be applied, other methods that are more suitable under the circumstances should be used. However, this should be justified both economically and legally, and the application of a different method cannot normally be justified when one of the above-prescribed methods is applicable.

Taxpayer-initiated adjustments

10 Can a taxpayer make transfer pricing adjustments?

Yes. Taxpayers must conduct their international dealings with related parties at arm's length and make transfer pricing adjustments in cases where a cross-border controlled transaction falls outside the arm's-length benchmark set by a transfer pricing study. The implementation of transfer pricing adjustments can be done gradually during the year with a settlement at the end of the fiscal year, or it can be done as a one-time adjustment at year-end.

Safe harbours

11 Are special 'safe harbour' methods available for certain types of related-party transactions? What are these methods and what types of transactions do they apply to?

On 5 September 2018, the ITA published two tax circulars: 11/2018 and 12/2018. The first circular distinguishes between activities that would be seen as consistent with a full-risk distributor, a limited-risk

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distributor and a marketing entity, and specifies the transfer pricing method that would be the most appropriate according to the ITA in each case. The second provides the ITA's indicative ranges for certain types of transactions (distribution, marketing and LVA services), as follows:

- distribution activity: a safe harbour of a 3 to 4 per cent operating margin for entities characterised as low-risk distributors;
- marketing activity: a safe harbour of a 10 to 12 per cent net cost plus (ie, markup) imposed on service costs; and
- LVA services: a safe harbour of a 5 per cent markup, in accordance with the OECD Guidelines and Actions 8 to 10 of the OECD's project on base erosion and profit shifting.

Taxpayers that submit reports in accordance with the approach outlined in the first circular and whose results fall within the ranges provided in the second circular are exempted from the requirement to provide benchmarking support for the assertion that the transfer prices used are in accordance with market pricing. Nonetheless, the circular does not otherwise provide an exemption from the existing requirement to prepare transfer pricing documentation; the documentation simply need not include a benchmarking analysis if an exemption applies.

DISCLOSURES AND DOCUMENTATION

Documentation

12 Does the tax authority require taxpayers to submit transfer pricing documentation? Regardless of whether transfer pricing documentation is required, does preparing documentation confer any other benefits?

Under the transfer pricing regulations (the TP Regulations) there is no obligation to prepare a transfer pricing study (ie, local file). However, a taxpayer engaged in a cross-border controlled transaction is required to include in its annual tax return a special form (Form No. 1385) describing the transaction and its nature, including references to its price and other relevant terms and conditions, as well as additional details regarding the implemented transfer pricing method, the profitability rate used for the transactions and whether the transactions reported are based on the new safe harbours set forth in Circular 12/2018.

In practice, taxpayers in Israel are expected to hold up-to-date transfer pricing documentation, which includes (at a minimum) a transfer pricing study and an intercompany agreement relevant for the fiscal year end.

Full documentation

Full documentation includes a transfer pricing study that comprises:

- a description of the principle intercompany transactions and the parties involved in these transactions, including a description of the management structure of the parties and functional organisational charts;
- a description of the business environment and the economic circumstances in which the parties operate;
- functional analysis of the parties involved in the intercompany transactions, including the functions performed, the risks assumed and the resources employed;
- selection of the pricing methods and the reasons behind the selection;
- economic analysis (determination of arm's-length prices); and
- the conclusions that may be derived from the comparison with uncontrolled comparable companies.

Additional documents that corroborate the data described above include:

- intercompany contracts;
- any disclosure made regarding the controlled transactions to any foreign tax authority, including any request for an advance pricing agreement;
- a transfer pricing policy, if applicable;
- any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns; and
- any opinions from an accountant or lawyer, if those were given.

According to the Israeli transfer pricing rules, the initial burden of proof lies with the taxpayer. As such, companies that do not transact at arm's length, or that do not hold the required transfer pricing documentation (proving their compliance with the arm's-length principle), may be exposed to penalties and to a change of pricing as determined by the Israel Tax Authority (ITA) at its discretion. These companies would be required to adjust their net income to incorporate the appropriate transfer prices for their intragroup transaction. This unilateral adjustment could lead to double taxation regarding income taxed in other jurisdictions.

Country-by-country reporting

13 Has the tax authority proposed or adopted country-by-country reporting? What are the differences between the local country-by-country reporting rules and the consensus framework of Chapter 5 of the OECD Transfer Pricing Guidelines?

On 4 January 2017, a proposed piece of legislation regarding the adoption of new transfer pricing documentation provisions in respect of Action 13 of the OECD's project on base erosion and profit shifting, which amends the Tax Ordinance (the Ordinance), passed the first reading (out of three) in the Israeli parliament; however, the applicable effective date of the proposed legislation has not yet been determined.

The proposed legislation updates the provisions of the TP Regulations and adds sections 85B and 85C to the Ordinance. According to the proposed legislation, in addition to the regular local file (ie, the transfer pricing study), Israeli taxpayers that are part of a multinational group will also be required to submit data at the corporate level: a master file accompanied with related data of the multinational group. In addition, an Israeli taxpayer who serves as the ultimate parent of a multinational group whose consolidated turnover exceeds 3.4 billion shekels will also be bound to submit a country-by-country report.

Timing of documentation

14 When must a taxpayer prepare and submit transfer pricing documentation?

Under the TP Regulations, there is no stated requirement in respect of whether the documentation must be contemporaneous with the company's tax filings. However, it is recommended to prepare a transfer pricing study and update it on an annual basis.

Where the facts of the transactions under review have not changed materially (or at all), the entire transfer pricing study can remain the same except for the benchmark results, which should be updated every year. It is best practice to perform a new search every three years and update the results of the original search on an annual basis.

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Failure to document

15 | What are the consequences for failing to submit documentation?

According to the TP Regulations, the tax assessing officer may issue the taxpayer a formal letter of request, requiring the taxpayer to submit, within 60 days, all relevant documentation and other information related to the intercompany transaction. The 60-day period may be extended, depending on the case, where any failure to submit information may trigger penalties and fines.

Penalties are uncommon in Israel and, although discussed as a possibility, have not yet been enacted. Adjustments, linkage, interest and statutory fines on assessments, which already appear in the Ordinance, currently apply to transfer pricing as well.

In this respect, in the past, ITA officials have indicated that submitting a Form No. 1385 that includes a personal affidavit by a company's officer that is subsequently found to be erroneous can lead to criminal liability, although the liability has not been imposed to date.

ADJUSTMENTS AND SETTLEMENT

Limitation period for authority review

16 | How long does the tax authority have to review an income tax return?

The statute of limitation is up to four years (usually three years, which can be extended to four years). The time period starts from the end of the fiscal year (FY) in which a taxpayer submitted its tax return. For example, in the case of a taxpayer who submitted the tax return of FY 2017 during FY 2018, the Israel Tax Authority (ITA) can audit FY 2017 until the end of FY 2022.

In the event of fraud or intentional misrepresentation, there is no limitation in reopening tax assessments for closed years.

Rules and standards

17 | What rules, standards or procedures govern the tax authorities' review of companies' compliance with transfer pricing rules? Does the tax authority or the taxpayer have the burden of proof?

The ITA follows the approach prescribed by the OECD Guidelines and its own inter-operation of transfer pricing rules that are described in detail in transfer pricing-related tax circulars. Principally, the initial burden of proof lies with the taxpayer and is transferred to the ITA once a complete transfer pricing study has been submitted. Nevertheless, the submission of a transfer pricing study alone does not necessarily shift the burden of proof to the ITA.

Tax Circular 1/2020 reiterates the views of the ITA on when the burden of proof in transfer pricing audits shifts from the taxpayer to the ITA. According to the Circular, in cases where there is a disagreement on the factual grounds upon which the study relied, the burden of proof remains with the taxpayer and does not shift to the assessing tax officer as the taxpayer has the full knowledge to justify the facts relating to the assessed transaction. This is relevant in cases where the tax authority 'reclassified' the form of the transaction; that is, 'new recharacterisation' based on the disagreement on the factual background and delineation of the intercompany transaction in the transfer pricing study.

In rare cases where a transaction between related parties lacks any commercial rationale (ie, the same transaction under similar economic circumstances would not have been agreed between non-related parties), the ITA may choose not to recognise the transaction in its original form and may treat it as an entirely different type of transaction – a type of transaction that, in its view, would reflect the business reality of the transaction in a more adequate manner. In those cases, the burden of proof lies with tax authority to justify its standing.

In addition, in cases where an incomplete transfer pricing study has been filed (a study missing: a complete search process; the reasoning for choosing the applicable transfer pricing method; the reasoning for choosing the comparables; financial data of comparables, etc), or where the taxpayer did not submit a transfer pricing study at all, the results will be the same, and the ITA can set the tax assessment without the need to provide a complete study on its behalf. While the ITA inspectors cannot set this arbitrarily, they can base the assessment upon their general experience and past assessments, as well as on estimations.

Disputing adjustments

18 | If the tax authority asserts a transfer pricing adjustment, what options does the taxpayer have to dispute the adjustment?

Under a tax audit, if the results of the cross-border controlled transaction fall outside the relevant arm's-length benchmark, the ITA will enforce an adjustment to the median value of the benchmark, usually accompanied by a secondary adjustment to demonstrate pricing compliance from an income tax perspective.

Principally, once a tax assessment has been made, resulting with a transfer pricing adjustment, taxpayers can dispute the proposed transfer pricing adjustments by means of appeals and with the courts, and through the use of treaties (where relevant).

Transfer pricing cases are rarely adjudicated in court in Israel. Since the adoption of the transfer pricing regulations 14 years ago, very few transfer pricing cases have been submitted to the courts, with most cases being settled with the ITA out of court.

RELIEF FROM DOUBLE TAXATION

Tax-treaty network

19 | Does the country have a comprehensive income tax treaty network? Do these treaties have effective mutual agreement procedures?

Yes.

Requesting relief

20 | How can a taxpayer request relief from double taxation under the mutual agreement procedure of a tax treaty? Are there published procedures?

Address the competent authority (the tax authorities).

When relief is available

21 | When may a taxpayer request assistance from the competent authority?

Prior to or during the audit and prior to judicial resolution.

Limits on relief

22 | Are there limitations on the type of relief that the competent authority will seek, both generally and in specific cases?

Not applicable.

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Success rate

23 How effective is the competent authority in obtaining relief from double taxation?

The competent authority is effective, but there are no statistics available. The number of mutual agreement procedure processes and advance pricing agreements adopted in Israel is low as the matter is relatively new.

ADVANCE PRICING AGREEMENTS

Availability

24 Does the country have an advance pricing agreement (APA) programme? If so, is the programme widely used? Are unilateral, bilateral and multilateral APAs available?

The transfer pricing regulations stipulate in article 85A(d) the conditions under which an APA may be concluded and delineates the scope of an APA.

APAs are not common in Israel, although they exist (statistics on APAs are not publicly available), and settlement can sometimes also be carried forward as part of an APA. However, settling a past audit cannot guarantee the same treatment in the future unless an APA is reached.

Available types of APAs include unilateral, bilateral and multilateral APAs.

Process

25 Describe the process for obtaining an APA, including a brief description of the submission requirements and any applicable user fees.

An APA is a tool that taxpayers can use to cover their international dealings and reach a prior agreement with the Israel Tax Authority (ITA) on the pricing of those dealings. However, there is no specific guidance on the on the content of an APA application. An initial APA request should be sent to the Transfer Pricing Department (TPD) of the ITA and include:

- the essential facts;
- the transfer pricing documentation;
- relevant documents, approvals, opinions, declarations, estimates and agreements;
- a description of the intercompany transactions; and
- the taxpayer's proposed consideration for the transactions, including the profit level margin.

Time frame

26 How long does it typically take to obtain a unilateral and a bilateral APA?

The ITA has a 120-day time frame within which it must approve or reject an APA application; however, a 60-day extension may be granted where notice is given to the taxpayer. If the ITA does not issue its decision within the time limits provided, approval of the APA will be considered to have been given, and the transaction subject of the APA will be deemed to be at arm's length. It is not uncommon to hold a meeting with the ITA prior to formally initiating the process.

Duration

27 How many years can an APA cover prospectively? Are rollbacks available?

The validity period for an APA is usually five consecutive years or less, as agreed between the taxpayer and the ITA. The APA provisions are prospective in nature, and there is no option for rollback.

There is no specific guidance for a renewal procedure. In practice, the ITA supports APA renewals; however, the procedure is similar to that for initial APAs.

Scope

28 What types of related-party transactions or issues can be covered by APAs?

APAs cover any type of international transaction carried out between related parties.

Independence

29 Is the APA programme independent from the tax authority's examination function? Is it independent from the competent authority staff that handle other double tax cases?

No, the competent authority in charge is the TPD, which is part of the ITA.

Advantages and disadvantages

30 What are the key advantages and disadvantages to obtaining an APA with the tax authority?

An APA provides the following benefits:

- certainty in respect of the tax outcome of the taxpayer's international transactions by agreeing, in advance, the arm's-length pricing or pricing methods to be applied to the taxpayer's international transactions covered by the APA;
- removal of an audit threat (minimising the rigours of audit) and deliverance of a particular tax outcome based on the terms of the agreement;
- the possibility of establishing a good relationship with the tax authorities;
- prevention of future transfer pricing adjustments and double taxation of results at the group level;
- substantial reduction of compliance costs over the term of the APA for the taxpayer as it is not necessary to prepare a transfer pricing study for the transactions covered by the APA during its validity period; and
- for tax authorities, reduction of the cost of administration and the freeing up of scarce resources.

The disadvantage of an APA is the comprehensive transparency it involves, and the relatively long time period required for completion in comparison to a transfer pricing study.

SPECIAL TOPICS

Recharacterisation

31 Is the tax authority generally required to respect the form of related-party transactions as actually structured? In what circumstances can the tax authority disregard or recharacterise related-party transactions?

Where there is a disagreement on the factual grounds on which the transfer pricing study relied, the tax assessing officer can recharacterise the form of the transaction. In rare cases where a transaction between the related parties lacks any commercial rationale, the Israel Tax Authority (ITA) may choose not to recognise the transaction in its original form and may treat it as an entirely different type of transaction – a type of transaction that, in its view, would reflect the business reality of the transaction in a more adequate manner. Non-recognition can be contentious and a source of double taxation, and, although derived from the transfer pricing regulations (the TP Regulations), it is also based on section 86 of the Tax Ordinance.

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Selecting comparables

32 What are some of the important factors that the tax authority takes into account in selecting and evaluating comparables? In particular, does the tax authority require the use of country-specific comparable companies, or are comparables from several jurisdictions acceptable?

Local comparables are preferred but are not often available. With evidence that a search for local comparables yielded no results, the use of European or US comparables may be accepted, as well as global benchmarks, so long as applicable adjustments were made (when required). However, this is examined on a case-by-case basis.

Secret comparables

33 What is the tax authority's position and practice with respect to secret comparables? If secret comparables are ever used, what procedures are in place to allow a taxpayer to defend its own transfer pricing position against the tax authority's position based on secret comparables?

Currently, no secret comparables are used by the ITA.

Secondary adjustments

34 Are secondary transfer pricing adjustments required? What form do they take and what are their tax consequences? Are procedures available to obtain relief from the adverse tax consequences of certain secondary adjustments?

The ITA is entitled to impose secondary adjustments and does so in practice. In cases where, upon an audit, the intercompany transaction has not been reported at arm's length, the difference between the price set between the related parties and the arm's-length price will be subject to a primary transfer pricing adjustment.

In addition, a secondary adjustment will be required by the ITA. The additional income derived from the primary transfer pricing adjustment (assuming the funds in the amount of the difference are not transferred) may be classified as an interest-bearing loan (an arm's-length interest), or it may be deemed as a dividend distribution according to the circumstances of the matter. In the case of the latter, a withholding liability may arise.

Non-deductible intercompany payments

35 Are any categories of intercompany payments non-deductible?

Management fees are deductible if conducted at arm's length. There are also no deductibility limitations on interest payments derived from intercompany loans; thin capitalisation rules are not often enforced in Israel. This issue will be resolved when Israel implements the recommendation prescribed under Action 4 of the OECD's project on base erosion and profit shifting (BEPS) and limits the interest payment amount deductible for income tax by applying a 'fixed ratio' (which equals a borrower's net deduction for interest or earnings before interest, tax, depreciation and amortisation (EBITDA) to 10 to 30 per cent) or a 'group ratio' (which equals a group's net deduction for interest or EBITDA).

Anti-avoidance

36 What legislative and regulatory initiatives (besides transfer pricing rules) have the government taken to combat tax avoidance with respect to related-party transactions? What are the penalties or other consequences for non-compliance with these anti-avoidance provisions?

Some tax positions and certain forms of transactions require specific reporting.

Location savings

37 How are location savings and other location-specific attributes treated under the applicable transfer pricing rules? How are they treated by the tax authority in practice?

There is no specific guidance regarding location savings. In principle, the TP Regulations do not apply to domestic transactions; however, the ITA may apply transfer pricing rules within Israel in cases where there might be difference in corporate tax rates owing to the status of 'preferred company' or 'preferred technology company' and, in general, require transactions to be at arm's length.

Branches and permanent establishments

38 How are profits attributed to a branch or permanent establishment (PE)? Does the tax authority treat the branch or PE as a functionally separate enterprise and apply arm's-length principles? If not, what other approach is applied?

The ITA follows the new OECD Guidelines concerning profit attribution to a PE. When attributing profits to a PE or branch, the ITA considers the PE or branch as a separate entity located in Israel, and, based on its activity (distribution, services or non-routine activity), it will establish the arm's-length profitability applicable to the PE or branch and tax it accordingly.

In this regard, the ITA issued Tax Circular 4/2016, stipulating its approach for deeming digital sales activity by a foreign company as a PE in Israel. This Circular, inspired by BEPS Action 1 concerning the digital economy, provided new guidelines and rules under which foreign companies' income derived from selling products or providing services through the internet to Israeli residents (digital activity) will be deemed the income of a PE in Israel for tax purposes. The Circular distinguishes between foreign enterprises that are residents of a treaty state (treaty resident companies) and foreign enterprises that are residents of a non-treaty state (non-treaty resident companies) and provides different rules for determining the income attributed to the Israeli PE for each of the aforementioned company types.

Exit charges

39 Are any exit charges imposed on restructurings? How are they determined?

Yes. There is a circular from the tax authorities that addresses their treatment of restructuring and move of functions, assets and risks.

Temporary exemptions and reductions

40 Are temporary special tax exemptions or rate reductions provided through government bodies such as local industrial development boards?

The Capital Investment Encouragement Act (including Amendment No. 73 to the Act) encourages enterprises and entrepreneurs, via the provision of tax benefits, to establish factories that would develop production capacity in the country, with an emphasis on the periphery (defined

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as 'preferred companies') and companies engaging in software development activities (defined as 'preferred technology companies'). Tax benefits include a reduced corporate tax rate (6 to 16 per cent), varied based on location and company type, and reduced dividend tax (zero to 20 per cent). Only income defined as 'preferred income' will be eligible for tax benefits under the Act.

UPDATE AND TRENDS

Tax authority focus and BEPS

41 **What are the current issues of note and trends relating to transfer pricing in your country? Are there particular areas on which the taxing authority is focused? Have there been any notable legislative, administrative, enforcement or judicial developments? In particular, how is the OECD's project on base erosion and profit shifting affecting both policymakers and tax administrators?**

As is appropriate in this post-BEPS era, the Israel Tax Authority (ITA) announced that it would adopt the BEPS principles as an amendment to the Tax Ordinance in respect of transfer pricing matters. At this stage, the amendment has already passed the first of three readings in the Israeli parliament. The applicable effective date of the proposed legislation has not yet been determined. Additionally, the ITA regularly publishes circulars announcing its position on various matters, such as safe harbours and applicable methods for pricing intercompany transactions, business restructurings and digital economy measures.

The ITA's increased focus on business or economic substance when analysing value chains and transactions involving the transfer or use of intangible properties indicates that functions contributing to the creation of value, as well as geographic locations, people functions and management, constitute important criteria when determining the appropriate attribution of profits among group members in multinationals. This also affects the government subsidies granted to research and development centres in Israel.

During audits, the ITA reviews the applicability of the profit split method in service transactions that include the provision of significant services contributing to the creation of profits (eg, research and development, marketing and management). Nonetheless, this is more of an evolution than a revolution as, because of the significant level of research and development activity in Israel, the ITA has already been focusing on, inter alia, matters similar to those presented by the BEPS principles; thus, we do not expect the nature of the audits to change but rather their intensity and scope.

The ITA's intention regarding the adoption of the recommendation promulgated under Actions 8 to 10 of the OECD BEPS Action Plan, in respect of intangibles, should be taken into consideration by Israeli tax practitioners when conducting their inspections of transactions in accordance with the new rules for hard-to-value intangibles. Greater emphasis should be placed on the attribution of profits based on value creation, and consideration should also be given to the principles on the development, enhancement, maintenance, protection and exploitation of intangibles.

Following the issuance of the OECD's final guidance on financial transactions on 11 February 2020, it is likely that intercompany loan transactions will be the focus of increased scrutiny by the ITA. Therefore, it is anticipated that the ITA's assessment will follow the approach outlined in the OECD's final guidance. It is, therefore, recommended that financing transactions be properly constructed and documented, focusing on a detailed description of the people functions involved and empirical evidence demonstrating the management and control of risks by relevant parties involved in a controlled financing transaction.

Eyal Bar-Zvi
barzvi@hfn.co.il

Asia House
4 Weizmann St
Tel Aviv 6423904
Israel
Tel: +972 3 692 5920
www.hfn.co.il

Although Israel has not yet enacted laws addressing digital economy taxation rights, the ITA has published Tax Circular 4/2016, which takes somewhat aggressive positions that, practically speaking, may subject almost every non-Israeli company active in the Israeli market to Israeli corporate income and value added taxes and registration obligations. For treaty-partner countries, the Circular expands the interpretation of a permanent establishment (PE) through a 'fixed place of business' or a 'dependent agent' in those tax treaties in the context of digital economy.

For companies resident in non-treaty jurisdictions, the Circular notes that the ITA will acquire taxation rights over a non-Israeli taxpayer based on domestic law principles (ie, business activity conducted in Israel, which generally requires a lower threshold than the PE treaty standard). One of the examples that the Circular cites as meeting this standard is the existence of a 'significant digital presence', even without a physical presence in Israel.

Given that the Circular interprets existing law and PE definitions, it applies retroactively. On this basis, many multinational companies with digital activities in Israel are undergoing audits for all open tax years, which are supervised by a special tax force at the ITA National Office.

Coronavirus

42 **What emergency legislation, relief programmes and other initiatives specific to your practice area has your state implemented to address the pandemic? Have any existing government programmes, laws or regulations been amended to address these concerns? What best practices are advisable for clients?**

No relief or other initiatives have been implemented regarding transfer pricing reporting and compliance. Extensions may be allowed.

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