# Annual International Bar Association Conference 2019

**Seoul, Korea**

**Recent Developments in International Taxation**

**Israel**

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**RECENT HIGHLIGHTS**

During the majority of 2018 and the beginning of 2019, the most significant international tax developments that took place in Israel include certain transfer pricing aspects relating to post-acquisition business restructuring, several court rulings and new policies related to other transfer pricing matters, the implementation of information exchange programs, and the entry into force of the Multilateral Instrument (the **"MLI"**) and certain bilateral income tax treaties.

## A. Business Restructuring

The Israel Tax Authority (the "**ITA**") published a comprehensive circular (the "**Circular**"), addressing the Israeli income tax aspects of a business model restructuring by multinational groups. This matter is commonly raised in recent tax audits of Israeli companies that were acquired by multinational groups, and following the closing of the acquisition, the intellectual property of the Israeli acquired company was transferred, or deemed transferred, to a non-Israeli affiliate, or the entrepreneurial aspects of the acquired company were terminated.

The Circular states that it follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations from 2017 (the "**OECD Guidelines**"). The Circular also adopts certain determinations of a District Court's decision regarding Gteko *vs*. Tax Assessor of Kfar Sava (the "**Gteko Decision**"), published June 2017, although some deviations from both of these authorities are apparent.

In short, the Circular was published in order to determine the manner in which a business restructure should be identified, whilst suggesting the proper methodology for evaluating the relevant value of functions, risk and assets ("**FAR**") that are deemed to be sold as a result of the business restructure. The Circular suggests a very aggressive identification approach and in practice we see that the ITA rules almost automatically in audits that FAR were transferred once a multinational entity acquires an Israeli company. The Circular then suggests a streaming chart in order to determine the value transferred. *De facto*, we see the ITA uses the acquisition price (with minor adjustments), in order to assign value to the alleged transferred FAR.

We should note that the Circular represents the ITA's interpretation of the law and accordingly, its position on said matters. The Circular does not, however, have any legal binding status and therefore, courts are not bound by it.

## B. Transfer Pricing

In 2018, a Supreme Court ruling regarding two combined court cases was published. The cases

were those of Kontera Technologies and Penisiar Israel. The Supreme Court ruled that the cost of stock options issued by a U.S. parent company to employees of its Israeli research and development subsidiary should be included in the subsidiary's cost base under a cost-plus transfer pricing method. The court also denied the Israeli subsidiary a corresponding tax deduction. The cost of the stock options was determined based on the stock option expense reflected in the Israeli subsidiary's financial statements. The result of this decision is a dramatic increase in the taxable income of any Israeli subsidiary working on a cost-plus basis, if its employees are granted any form of stock-based compensation (SBC). The ITA has published a notification based on the Kontera and Penisiar ruling, demanding taxpayers to retroactively amend their tax returns in order to be in line with the Supreme Court ruling.

Another development in the transfer pricing arena, is the publication of a circular by the ITA providing a 'safe-harbors' for transfer pricing methodologies in certain types of activities performed by Israeli subsidiaries of multinational groups. The 'safe-harbor' includes a cost + 5% for so-called "low value added services", a cost + 10%-12% for marketing services, and 3%-4% out of the turnover for distribution services by low risk distributers. It should be emphasized that the publication includes specific conditions in order to benefit from the 'safe-harbor'.

## C. Common Reporting Standards

New Israeli Income Tax Regulations, which were officially published on February 6, 2019 (the **"Regulations"**), implement the Common Standard on Reporting and Due Diligence for Financial Account Information **("CRS")**, which was developed by the OECD. Under the Regulations, Israeli financial institutions are required to report to the ITA annually financial information concerning non-Israeli residents with financial accounts in Israel.

On an annual basis Israel will automatically exchange such information with over 95 foreign countries in accordance with the bilateral and multilateral agreements on the exchange of information. As part of the exchange of information, Israel will receive financial information concerning the foreign accounts of Israeli residents (including information on financial income, as well as account balances).

It should be noted that the automatic exchange of information with certain countries, including Australia, Canada and the United Kingdom, will commence retroactively from 2017 onward (Israel will transfer and receive such information in July 2019), while the exchange of information with other countries, such as Switzerland, will commence from 2019 (Israel will

transfer and receive information in September 2019).

## D. MLI

On September 13th, 2018, Israel has informed the OECD that it has ratified the MLI, which was signed by the Minister of Finance on June 7th, 2017, and by that became the 11th country to ratify the MLI. The MLI came into force with respect to the relevant Israeli tax treaties on January 1, 2019. When checking the current version of a treaty in a country that has ratified the MLI, one would also need to check whether treaty provisions have changed due to the MLI.

Israel has chosen to implement the MLI on most of its existing treaties, and has submitted some reservations to the MLI provisions.

## E. Tax Treaties

In 2019, Israel has signed tax treaty agreements with the United Kingdom and Australia, however, those were yet to be brought into force. In addition, tax treaties with Austria, Armenia and Macedonia that were signed in previous years were brought into force during 2018 and 2019.