Legal Update: Tax **November 2019**

Digital Taxation Developments

Dear Clients and Colleagues,

The Base Erosion and Profit Shifting project ("**BEPS**") was aimed to combat tax avoidance by multinational enterprises ("**MNEs**") that exploit gaps and mismatches in the international tax regimes for the purpose of eroding their tax base and shifting profits from high-taxation jurisdictions to low or no taxation jurisdictions. The OECD identified the extraordinary challenges of the digital economy as one of the main focus areas and referred to it as part of the BEPS report (Action 1). In acknowledgement of the complex and broad implications of taxation of the digital economy, the OECD released in 2018 an "Interim Report" as a follow up to Action 1, further discussing the implications of the digital economy on the international tax system.

The OECD identified the issue of **"nexus"** as critical in determining which jurisdiction should have taxing rights over an MNE in the digital era. Under most tax treaties, business profits are taxed in the state of residence unless the MNE carries out business in another jurisdiction through a permanent establishment ("**PE**"). In the latter case, the profits that are attributable to the PE will be taxed in that jurisdiction. In most tax treaties, the traditional definition of PE is based on physical presence. In this digital world, however, an MNE may maintain a significant economic presence in a certain jurisdiction without actually having any physical presence there.

Furthermore, internationally accepted profit allocation methods are based on the arm's length principle. Therefore, even if an MNE has a PE, the allocation of profits in accordance with the arm's length principle will not always align with the location of the value creation within the MNE group. In a digital era where businesses can interact with clients remotely without the need (or with a minimal need) for physical presence, the place where the value is created and the place of taxation do not necessarily correspond.

The OECD (the Inclusive Framework) set a goal to deliver by 2020 a final report that includes a consensus approach of all participating countries to address the situation described above. In January 2019, the Inclusive Framework published a policy note, dividing the work with respect to the tax challenges of the digital economy into two "pillars":

1) Pillar one will address the allocation of taxation rights, focusing on issues related to

nexus and profit allocation.

2) Pillar two will address the remaining BEPS issues, recognizing that the tax challenges of the digital economy exacerbate such issues, and will aim to develop a set of rules that prevent MNEs from shifting profits to jurisdictions with low effective tax rates or no taxation at all.

In a subsequent policy note published in May 2019 the Inclusive Framework adopted a program of work (the "**POW**"), which outlined the work status, issues and proposals of the two pillars at that point. Two important developments in this process occurred recently:

1) On October 9, 2019 the OECD Secretariat published its proposal for a unified approach under pillar one (the "**Unified Approach**") as a public consultation document.

2) On November 8, 2019 the OECD Secretariat published a public consultation document with respect to pillar two – the Global Anti-Base Erosion Proposal (the "**GloBE Proposal**").

<u>The Unified Approach</u>:

The Unified Approach presents a new approach for establishing nexus and for allocating profits to jurisdictions generating income for an MNE. In particular, the Unified Approach proposes new rules for determining nexus, which are not dependent on physical presence, but rather are largely based on sales. Instead of treating the level of physical presence as nexus justifying right to tax, the new rules would use a revenue threshold (which could be adapted to the size of the market). The new revenue threshold would take into account activities directed at consumers in a certain jurisdiction, even where the revenues are generated in another jurisdiction (*e.g.* online advertising services directed at potential customers in Israel, where the paying clients (*i.e.*, suppliers) are located in France).

In addition to recasting the definition of nexus, the Unified Approach also proposes a profit allocation rule that is more nuanced than a pure application of the arm's length principle. While under that principle, pricing between two related parties must be the same as if the parties were not related, the Unified Approach proposes profit allocation rules based on the premise that routine profits (such as profits derived from marketing and distribution functions) may be taxed in accordance with the arm's length principle while non-routine profits (*i.e.,* the residual profit that goes beyond the regular operating profit) would be taxed by the jurisdiction where the economic value is created.

The Unified Approach offers a three-tier profit allocation mechanism:

a) ***Amount A*** – a portion of the deemed residual profit (*i.e.*, the profit that remains after the allocation of the routine profits) would be allocated to a market jurisdiction meeting the new nexus rule through a formula based on sales. This amount will reflect the new

taxing right.

b) ***Amount B*** – routine profits, related in particular to baseline marketing and distribution functions, would remain taxable and allocable in accordance with the arm's length principle. In view of the large number of tax disputes related to distribution functions, a fixed remuneration approach (*i.e.,* a fixed percentage that may vary by industry) would be considered in this regard.

c) ***Amount C*** – in the case of a tax dispute over amounts allocable to a market jurisdiction, an additional amount may be allocable through a legally binding and effective dispute prevention and resolution mechanism. Amount C mainly would be relevant in cases where functions performed in the market jurisdiction exceed the baseline marketing and distribution functions, and that jurisdiction seeks to tax the profits deriving from these extra functions in accordance with the arm's length principle.

The Unified Approach covers large consumer-facing businesses, from traditional "brick and mortar" businesses to highly digitalized businesses. Thus, the Unified Approach may apply to retail businesses that sell furniture online, as well as to businesses that provide software-as-a-service.

The GloBE Proposal:

In the GloBE Proposal, the OECD Secretariat proposed the following four rules - which were already presented in the POW in May 2019 - that are intended to prevent tax base erosion and profit shifting to jurisdictions with low effective tax rates:

1) An **income inclusion rule** that would tax the income of a foreign branch or a subsidiary of an MNE that is subject to tax at an effective rate below a pre-determined minimum tax rate. As this rule focuses on the **effective** tax rate and not on the theoretical corporate tax rate, an important issue that arises is how to calculate the tax base (*i.e.,* the amount of taxable profits), in order to determine the effective tax rate.

2) An **undertaxed payment rule** that would deny a deduction or impose withholding tax in cases where a payment to a related party is subject to tax below the pre-determined minimum tax rate.

3) A **switch-over rule** that would ensure that the income inclusion rule would apply to foreign branches as well as foreign subsidiaries, by permitting the tax residence jurisdiction of an MNE to switch from the exemption model (*i.e*., exemption from tax with regard to profits attributable to a permanent establishment that were taxed in the PE ("source" jurisdiction) to a credit method (*i.e.,* granting credit to an MNE for taxes paid in the source jurisdiction). Under the credit method, profits that are subject to an

effective tax rate below the minimum pre-determined tax rate would be taxed under the income inclusion rule.[1]

4) A **"subject to tax" rule** that would ensure that tax treaty benefits are granted only where the item of income was subject to tax at the pre-determined minimum tax rate.

The GloBe Proposal raises three major outstanding issues:

1) How would the tax base be calculated for the purpose of the income inclusion rule? Can the financial accounts be used as a starting point? What adjustments should be made to the financial accounts?
2) To what extent can an MNE blend high-tax income and low-tax income from different sources?
3) Which carve-outs should exist? For example, an effective tax rate resulting from a tax incentive that is consistent with the standards of BEPS Action 5 on harmful tax practices could be carved out. The carve-out issue may have significant consequences for Israel, as the sustainability of the tax incentives under the Israeli Law for Encouragement of Capital Investment, 5719-1959 may depend on a carve-out.

<u>The application of these developments in Israel</u>

Israel, like many other countries, is not content with the current international tax system. While Israel continues to monitor international taxation developments, particularly in the OECD, the Israel Tax Authority (the "**ITA**") began its own BEPS-style initiative in 2016 with the release of Tax Circular No. 04/2016 (the "**Circular**"), which clarifies the circumstances in which a foreign enterprise engaged in online activities may be liable to corporate income tax and VAT in Israel.

The Circular is based on the premise that the traditional determination of the place where business income is generated, which focuses on the physical presence of an MNE, is no longer a satisfactory model. The Circular clarified that an MNE providing online services in Israel may be taxed in Israel if its activities create a significant economic presence in Israel, even if it does not have any physical presence in Israel.

The Circular set new nexus rules, based on significant economic presence rather than physical presence. The new nexus rules in the Circular apply only to MNEs that are residents of countries that do not have double tax treaties with Israel.

In addition, the ITA is trying to advance two legislative initiatives in this regard:

VAT Initiative. Under a bill initiated in 2016 by the ITA, foreign residents providing digital services to Israeli consumers would have to register for VAT purposes in Israel through a special

[1] The relevance of this rule to Israel is limited, as Israel generally applies the credit method.

registration procedure. The bill would impose VAT liability on foreign residents that provide digital services to Israeli private consumers. Although this proposal has not progressed significantly since its introduction, the ITA is continuing to explore the imposition of VAT liability on foreign entities providing digital services in Israel.

Turnover Tax Initiative. Recent informal publications indicate that the ITA has been working on new legislation that would impose taxes on the turnover of digitalized businesses operating in Israel. This new legislation, if enacted, would provide Israel with a new taxing right, which would not necessarily be limited by current law or tax treaties, which are the baseline for the Circular.

Legislation recently enacted in France may provide a relevant yardstick in this regard for Israel. In July 2019, France's Senate approved a 3% digital tax for companies that generate global digital service revenues of at least 750 million euros. Shortly after the vote in the Senate, President Trump threatened to retaliate by imposing a tax on French goods, particularly wine. At the G7 summit in August 2019, French President Macron announced that the US and French administrations reached a compromise regarding the controversial digital tax. Macron also promised to repeal the digital tax if an international agreement on digital tax is reached. While the US is the country that is expected to be most heavily affected by digital tax initiatives, the imposition of a digital tax in Israel may raise sensitive issues and have broad political implications. The threats of the Trump administration with respect to digital tax initiatives around the world may suggest that a digital tax not be readily adopted in Israel.

Sincerely,

Fischer Behar Chen Well Orion & Co

Updated written by: Adv. Uri Lampert (CPA)

For further information, please contact:

Adv. Anat Shavit	ashavit@fbclawyers.com	+972-3- 6944203
Adv. Ron Lehmann	rlehmann@fbclawyers.com	+972-3- 6944145
Adv. Uri Lampert (CPA)	ulampert@fbclawyers.com	+972-3- 6944203

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