



Client Update | Tax

New OECD Proposal for Taxing Digital Economy – The Israeli Tax Angle

October 2019

Dear Clients and Friends,

On October 9, 2019, the OECD released a Public Consultation Document, the Secretariat Proposal for a Unified Approach under Pillar One (the “**Unified Approach**”). If implemented, the Unified Approach would bring significant changes to international taxation rights and would impact many multinational companies with online activities, by providing market countries with taxing rights.

Several countries have been taking unilateral measures to address the taxation of non-resident companies’ activities over the Internet. The Unified Approach is intended to provide a consensus among countries on this issue in an attempt to adopt a harmonized approach to taxation of digital activities. Recognizing that the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence, the Unified Approach is based on the following elements: scope, economic nexus, a new approach to profit allocation and binding dispute resolution.

In terms of scope, the Unified Approach covers mainly (but not only) highly digital companies, with a broad focus on consumer-facing businesses (sales of goods or provision of digital services that are consumer-facing). Under the Unified Approach, economic nexus is no longer dependent on physical presence in order to acquire taxation rights over a non-resident taxpayer’s revenues from digital activities. Rather, economic nexus can be established based on a certain sales threshold (adjustable based on the size of a particular market to ensure smaller markets get their fair share), while taking into account additional factors such as online advertising targeted at a specific market. The economic nexus concept would be introduced by incorporating a standalone treaty provision into the OECD Model Convention.

The Unified Approach introduces a new three-tier profit allocation methodology aimed at increasing tax certainty. Applicable to companies within the scope, the methodology goes beyond the arm’s length principle and disregards whether or not the company sells to a specific market via a permanent establishment (“**PE**”), a distribution center or unrelated distributors. The three-tier profit allocation proposal is as follows:



- ▶ Amount A: provides a new taxing right to a jurisdiction over a portion of “deemed residual profit” of a multinational group allocated to market jurisdictions, namely, the profit that remains after allocating what would be regarded as a deemed routine profit on activities to the countries where the activities are performed. Dispensing with the dependency on arm’s length benchmarking, the Unified Approach would use a sales-based formula to determine the portion of deemed residual profit that would be taxed by market or user jurisdictions;
- ▶ Amount B: a fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction based on existing rules (e.g., transfer pricing under the arm’s length principle); and
- ▶ Amount C: binding and effective dispute resolution mechanisms relating to the foregoing, including any additional profit where in-country functions exceed baseline activities.

While Israel has not yet enacted laws addressing digital economy taxation rights, the Israel Tax Authority (the “ITA”) published ITA circular 4/2016 (the “Circular”) 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 prior coverage on the Circular, please refer to our client update here: <http://www.hfn.co.il/client-update-activity-non-israeli-companies-israel-through-internet>.

For treaty-partner countries, the Circular expands the interpretation of a PE through a “fixed place of business” or a “dependent agent” in such tax treaties in the context of digital economy.

- ▶ Fixed Place of Business PE: The Circular states that a PE may exist even where there is no Internet server located in Israel, and notes that certain activities of representatives and employees of an Israeli affiliate of a non-resident company in Israel (e.g., identifying potential clients, marketing activities and client relationship management) when conducted with assistance from, or through, a place of business in Israel, may create a PE. In effect, the ITA’s position is equivalent to attributing the activities of an Israeli affiliate of a multinational group to a non-Israeli affiliate within the group.
- ▶ Dependent Agent PE. With respect to creating a PE through a “dependent agent”, the Circular adopts the “principal role” approach pursuant to which increased involvement of the agent in Israel in negotiations on behalf of, and decisions that bind, a non-Israeli company, reinforce the conclusion that the dependent agent will be treated as a PE of such company. Under this approach as well, if employees of an Israeli affiliate of a multinational group perform substantive activities that lead to binding contracts, a PE in Israel may be established (by essentially deeming such employees as dependent agents of a non-Israeli affiliate within the multinational group).

For companies resident in non-treaty jurisdictions, the Circular notes that the ITA will acquire taxing rights over a non-Israeli taxpayer based on domestic law principles (namely, 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 “significant digital presence” even without a physical presence in Israel. Indications of the existence of a digital presence in Israel include a significant number of contracts signed with Israeli residents via the Internet, a significant number of customers in Israel that consume the services provided by such company, and the services over the Internet have been adapted to suit Israeli customers such as a website in Hebrew, using local currency and local credit card clearance.

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.

While some concepts of the Unified Approach may be in line with the ITA’s positions as reflected in the Circular, such as the need for an approach that would grant taxing rights based on economic nexus as opposed to traditional physical presence, the OECD proposal underlines the fact that legislative change is required in order to adopt these positions and that this should be done in coordination with other countries and not unilaterally. The positions of the ITA in the Circular are by far more aggressive than the Unified Approach and are indicative of a much broader approach in the allocation of taxing rights.

The ITA’s policy and positions in the Circular have also been criticized in the past in a report published in November 2016 by the State Comptroller and Ombudsman of Israel, indicating that in light of the importance of the rules established in the Circular, the ITA should consider enacting them in legislation. Until then, based on the said report, the ITA will likely face difficulties in its enforcement capabilities and efforts to combat international tax planning schemes. As noted, Israel has not yet adopted any such legislation and it is yet to be seen what impact, if any, the publication of the Unified Approach will have on this issue.

In addition to the Circular, the ITA released circulars 11/2018 and 12/2018, which define transfer pricing safe harbor rules for marketing and distributorship activities by multinational groups in Israel, based upon which the ITA is taking active steps and conducting audits of Israeli subsidiaries of multinational groups by challenging the characterization and pricing of their activities in Israel.

Our tax team has vast experience in handling both Israeli income tax and value added tax audits of digital economy multinational groups as well as restructuring activities in the Israeli market to minimize Israeli tax exposures and related transfer pricing matters. We are at your disposal to provide comprehensive advice targeted to the specific circumstances of your company. We will keep you updated as to any developments in this area.

Sincerely,

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