Tax Justice Network Israel

Executive Summary

A Proposal to Adopt a Reform in Taxing Multinational Corporations in Israel - Unitary Taxation

Tel Aviv, February 2015

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EXECUTIVE SUMMARY

In the first decade of the 21st century, it is apparent that multinational corporations (corporate groups that operate globally through various types of affiliates and are generally referred as MNCs) are key players in the global economy and also play an important role in Israel's economy. Alongside MNC's increasing influence over the world economy, such entities have developed complex techniques for reducing their overall income taxes by taking advantage of loopholes in national tax systems, inter alia, by exploiting the use of transfer pricing within the MNC's group, by using treaty shopping techniques, or by demanding tax holidays from local governments as a precondition to open plants and operate in these states. The report attempts to critically examine how successful the current Israeli tax rules are in taxing MNCs that operate in Israel. The importance of this report, whether a unitary tax system (as further explained below) will be adopted in Israel or not, is in bringing this discussion on the Israeli public agenda and in providing the architects of the Israeli tax system a detailed analysis of the advantages and flaws of the current tax rules as well as of the different solutions that are currently under consideration.

In 2003 the state of Israel adopted a worldwide tax basis and since then has been amending its tax rules to combat aggressive tax planning by individuals and mainly by companies (e.g. rules regarding controlled foreign companies' regulations, taxation of trusts and transfer pricing have been added in recent years). In 2010, Israel was admitted to the OECD as a full member and upon its admittance it undertook to base its tax law on the arm's length principle.

During our study we concentrated on one of the methods that MNCs use to avoid current Israeli income taxes, a method that is generally referred as exploiting transfer pricing. Through exploiting transfer pricing, the goal of reducing income tax liability is generally achieved by the MNC either by forming foreign affiliates that own assets (e.g., intellectual property rights, bonds, and shares) in intermediary favorable jurisdictions that often serve as tax havens. Another common method used by such MNCs is to allocate profits and costs among different members of the MNC group and by doing that to reduce the overall tax liabilities of the group ("base erosion" or "profit shifting"). These techniques rely heavily on the separate entity doctrine and on the arm's length principle which the state of Israel is obligated follow as a member in the OECD.

This report explores why Israel's existing tax regime has difficulties in combatting MNCs tax evasion efforts in Israel and why a unitary tax approach could probably be a better solution to the existing system that relies heavily on the arm's length fiction. The unitary tax system in a nut shell replaces the outdated principle of separate entity by treating MNCs and their subsidiaries as a single business entity and by disregarding intra-company transactions. The unitary tax system requires that MNCs prepare a single set of combined or consolidated accounts and Country by Country reporting in every country of operation. Then, the overall profit is apportioned according to a weighted formula which allocates income and gains among the states the MNC operates in based on the added value each such state is responsible for.

We are aware that a unitary income tax system also presents unresolved issues such as political and technical issues, some of which are in differentiating between the different operations and some of which in forming the formula that would assist in allocating the

income/expenses. However, we strongly believe that unlike the OECD BEPS action plan, this alternative could work. We find it difficult to believe that strengthening the CFC legislation, transfer pricing legislation and permanent establishment definition – all of which rely on the separate entity and arm's length principles-would suffice. In our view, establishing an income tax system that relies on anachronistic principles is unrealistic and more importantly impractical.

Our findings/conclusions are as follows:

1. Profit Split Methodology- It is apparent that the current tax rules in general, and the transfer pricing regime in particular, are challenged by the aggressive tax conduct of MNCs. Recent studies show that developed countries lose revenues between USD 850 billion to USD 1,100 billion each year a considerable portion of it is due to MNCs tax conduct (based on TJN research project). We unfortunately do not have empirical figures regarding the magnitude of such phenomenon in Israel. Nevertheless, it is clear that Israeli companies engage in profit shifting. Since the current transfer pricing methodologies heavily rely on the existence of comparable transactions/products and since experience shows such comparables are usually difficult to find, the existing regime (especially regarding transactions that involve intellectual property) is ineffective and impractical. Determining a comparable transaction or goods is also very subjective and would probably invite controversies between the taxpayers and the tax authorities which spend valuable resources. We therefore recommend using a hybrid approach that allocated income according to MNCs expenses (profit split methodology) and whatever left to allocate such residual portion according to unitary tax concept. This hybrid proposal which was raised by Professor Reuven S. Avi-Yonah, Kimberly Clausing and Michael Durst will allow the tax authorities to better adjust to this change rather than to face a radical reform (change from separate entity approach and arm's length to unitary tax approach).

2. Consolidation - Even though tax consolidation between Israeli companies in not entirely prohibited, such consolidation is rarely applied. First, the Israeli tax law allows such consolidation for tax purposes only for Israeli industrial companies. Second, the Israeli tax law does not provide tax consolidation. Rather, it allows aggregation of the bottom line results of both companies if the parent owns at least 67% of the subsidiary and as long as the two companies engage in the same line of business (alternatively, if the parent is not classified as an industrial company, such consolidation is also permitted if 80% of the parent's assets is the industrial subsidiary). We therefore recommend broadening tax consolidation between Israeli companies and possibly in the future, tax consolidation in MNCs between Israeli and foreign affiliates in corporate groups.

3. Information (collection and analysis)- In order to better assess the magnitude of these issues in Israel, we reached out to the Israeli tax authorities and requested information regarding the impact of base erosion profit shifting in Israel. We also wanted to know how common it is for Israeli companies to consolidate their tax statements. We were answered that the Israeli tax authority does not collect such information and as such is in unable to process our requests for information. Nevertheless, we were told by the Israeli tax authority that Israeli companies and Israeli subsidiaries engage in base erosion and such activities tend to involve transfer of intellectual property from Israel and royalty payments from Israel. We therefore recommend that the Israeli tax authority will start collecting such information and also form a unit that would analyze these issues.

4. Cooperation – We also address the concern that replacing the existing tax regime with a unitary tax system without a multilateral cooperation would not work. First, we believe that Israel's existing treaty network should almost be unchanged (46 out of Israel's 53 bilateral tax treaties support unitary approach), and second, experience shows that most international tax practices started by unilateral actions. Nevertheless, we believe that Israel's recent legislation bills that would allow cooperation and collaboration with countries whether Israel concluded a tax treaty with such countries or not as well as multilateral treaty that would allow exchange of information would increase cooperation and are in the right direction.