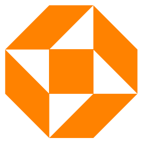


Morison Global

Global Tax Insights

Q2 2023

Building Better
Business Globally

Editorial

Sachin Vasudeva
SCV & Co. LLP, India
E: sachin.vasudeva@scvindia.com

The minimum standard on treaty shopping now covers 100 jurisdictions and around 1,850 bilateral treaties

BEPS Action plan 6 identified treaty shopping and treaty abuse as one of the principal concerns and therefore this was agreed as a minimum standard by all the participating countries. The countries also agreed to subject their efforts to an annual peer review. The fifth peer review report reveals that the members are respecting their commitment to implement the minimum standard on treaty shopping and confirms implementation of the multilateral instrument (MLI) as the tool adopted by majority of the jurisdictions for this purpose. The report further reveals that the impact and coverage of the MLI is expected to continue to increase as jurisdictions complete their ratifications. As per the report MLI covers 100 jurisdictions and around 1,850 bilateral treaties. In a significant move, the Australian government announced its decision to implement 15% global minimum tax for large multinational enterprises with the income inclusion rule (IIR) applicable to income years starting on or after 1 January 2024 and the undertaxed profits rule (UTPR) applying to income years starting on or after 1 January 2025. Other countries – for instance, Belgium, South Africa and New Zealand – have also started taking steps to change their domestic legislation in conformity with the BEPS Pillar 2 recommendations.

As mentioned in the Q1 2023 editorial the UAE Corporate Tax (CT) Law has begun its innings from June 2023. To facilitate implementation, the authorities have issued several clarifications in the form of Cabinet and Ministerial Decisions. This issue of Global Tax Insights contains an article on the transfer pricing regime in the Emirates introduced as part of the UAE CT Law, alongside other articles on important tax issues.

Signing off with the following thought:

Trying to maintain control in this life is a bit like trying to maintain control on a roller coaster. The ride has its own logic and is going to go its own way, regardless of how tightly you grip the bar. There is a thrill and a power in simply surrendering to the ride and fully feeling the ups and downs of it, letting the curves take you rather than fighting them. When you fight the ride, resisting what's happening at every turn, your whole being becomes tense and anxiety is your close companion. When you go with the ride, accepting what you cannot control, freedom and joy will inevitably arise.

Happy reading!

Sachin Vasudeva

Limitation of interest deductions in Australia

CONTRIBUTED BY
Alexander Capan and **Chris Wookey**
Leebridge Group, Australia
E: alexander.capan@leebridgegroup.com.au
E: chris.wookey@leebridgegroup.com.au

In the 2022/23 October Budget, the government announced its intention to strengthen Australia's existing thin capitalisation regime to *"address risks"* to Australia's tax base in relation to the use of excessive debt deductions or, put another way, to change the limits applicable to interest deductions. The proposed changes are intended to give effect to the OECD's Base Erosion and Profit Shifting (BEPS) Action Item 4: *Limitation of Interest Deductions*.

On 16 March 2023 the Federal Government released draft legislation implementing the proposed changes. For general class investors, the introduction of earnings-based tests listed below will replace the previous asset-based tests.

Who do the changes apply to?

Both foreign-owned inwards and Australian-owned outwards investors and businesses, but not financial entities and authorised deposit-taking institutions such as banks.

When do the changes take effect?

Financial years commencing on or after 1 July 2023.

The Fixed Ratio Test (FRT)

The Fixed Ratio Test permits an entity to claim net debt deductions up to 30% of its 'tax EBITDA', ensuring that an entity's profits remain subject to tax in Australia and not soaked up by excessive debt deductions.

Under the Test, excess unclaimed debt deductions can be carried forward for up to 15 years and claimed in years where there is capacity under the FRT. The entity must have used the FRT in every income year since the deduction arose and must pass a modified 'continuity of ownership' test.

The FRT is referred to as the default test and will apply to the majority of general class investors that do not elect to use the Group Ratio Test or the External Third-Party Debt Test.

The Group Ratio Test (GRT)

The Group Ratio Test can be used as an alternative for those groups that are highly leveraged, allowing an entity to claim debt deductions in excess of the amount permitted under the FRT but still subject to a relevant financial ratio of the worldwide group.

This test requires an entity to calculate the ratio of its worldwide group's net third-party interest expense as a share of the group's 'accounting EBITDA' for an income year. This is called the Group Ratio Earnings Limit. Any net debt deductions that exceed this Limit for the income year will be disallowed.

The GRT is only available if the entity is a member of a relevant worldwide group.

The External Third-Party Debt Test (ETPDT)

The External Third-Party Debt Test allows all debt deductions attributable to third-party debt. General class investors cannot elect to use this test where:

- the entity has one or more associates that are general class investors for the income year; and
- those associate entities are not exempt from the thin capitalisation rules; and
- at least one of the associate entities does not make a choice to use the ETPDT.

These criteria effectively require a general class investor and all of its associate entities to make a common choice to use the ETPDT, so as not to maximise tax benefits by using a combination of different thin capitalisation tests.

Morison Global

Removal of interest deductions for NANE

Included in the draft legislation is an unexpected proposal to remove interest deductions relating to the derivation of non-assessable non-exempt (NANE) distributions from foreign non-portfolio investments. At present, an Australian company that debt-funds an offshore share acquisition is allowed a deduction for interest costs incurred even though dividend receipts from the offshore company are usually not taxable.

This will apply to arrangements existing before the legislation comes into effect and will treat interest as non-deductible where it was previously deductible.

Election of tests

An entity that chooses to apply the group ratio test or the external third-party debt test must make its election:

- in the approved form; and
- on or before the earlier of the day the entity lodges its income tax return for the income year and the day the entity is required to lodge its income tax return for the income year.

A choice for an income year cannot be revoked.

Interaction with transfer pricing rules

The transfer pricing rules will be amended to ensure that borrowings and interest rates of general class investors subject to the new thin capitalisation rules are consistent with arm's length conditions under the transfer pricing rules. Until now it has been a matter of dispute whether interest deductions allowable under the thin capitalisation regime could also be attacked under the transfer pricing regime.

This change appears intended to allow the Australian Taxation Office to use both weapons to attack relevant funding arrangements.

Morison Global

India raises non-residents' tax rate on royalty and fees for technical services from 10% to 20%

CONTRIBUTED BY
Nilesh Patel
Bhuta Shah and Co. LLP, India
E: nilesh.patel@bhutashah.com

The tax rate on royalties and FTS income of non-residents is increasing. This will affect non-residents, residents paying such income to non-residents and multi-national corporations

Introduction

Non-residents are taxable in India only on their India-sourced income. Income in the nature of royalties or fees for technical services (FTS), if deemed to arise in India, is considered as India-source income. So, such income is taxable in the hands of non-residents in India.

Section 115A of the Indian Income Tax Act, 1961 (ITA) sets the rate at which different streams of income are taxable in the hands of non-residents. Section 115A was amended by the Finance Act, 2015 to reduce the rate of tax on royalty and FTS income for non-residents from 25% to 10%. This reduction was done to reduce hardships faced by small entities under the 25% tax rate. The Amended Finance Bill 2023 increases this tax rate from 10% to 20% with effect from 1 April 2023. This change is likely to have several implications for non-residents.

Position before the increase

Before this recent amendment, the tax rate (10%) set under section 115A was either at par with certain Indian tax treaties, or lower than the rate under other tax treaties. As a result, several non-residents were not electing to be taxed under tax treaties and instead were paying taxes at the rate provided in section 115A, i.e. domestic law.

It should be pointed out here that under Indian domestic tax law, non-residents can choose to be taxed under a tax treaty between India and the country of residence of the non-resident or the ITA (domestic law), whichever is more beneficial. So, some non-residents can opt to be taxed at a rate below that prescribed in the tax treaty that applies to them.

However, when a non-resident opts to be taxed under domestic law, then section 115A exempts them from filing income tax returns in India if (i) such non-resident receives only dividend, interest, royalty and/or FTS income from India, and (ii) tax has been withheld at source from such income at a rate which is not lower than the rate provided under section 115A. This is an important benefit and relieves the burden of compliance.

But the exemption from filing a tax return in India is available only if non-residents do not opt to be taxed under tax treaties. If a non-resident takes the benefit of a lower tax rate under a tax treaty that applies to them, then they must file an income tax return in India.

Increase in compliance burden on non-residents

Increasing the tax rate on royalty and FTS income from 10% to 20%, under section 115A, may prompt more non-residents to opt to be taxed under relevant tax treaties, where these offer lower tax rates. To do this they must furnish a Tax Residency Certificate (TRC) and Form 10F. In addition, a non-resident also must show that they are the beneficial owner of the royalty and/or FTS income concerned.

Further, to obtain benefits of tax treaties non-residents will have to meet the conditions imposed by the principal purpose test (PPT) enshrined in tax treaties under the Multi-lateral Instrument, and ensure they do not run foul of the ITA's General Anti Avoidance Rule (GAAR).

To file an income tax return in India, non-residents will need to obtain a permanent account number (PAN) card in India. So, obtaining the benefit of a lower tax rate under tax treaties will increase the compliance burden on non-residents. In addition, where Indian residents making payments to non-residents have arrangements to withhold tax after grossing up royalty and FTS payments the cost for them will increase.

Building Better Business Globally

Morison Global

What if India has no tax treaty with a particular country?

The increase in the section 115A tax rate will apply to non-residents where India does not have a tax treaty with the jurisdiction that applies to them; for example, there is no treaty with Bahrain. The tax burden on these non-residents will increase.

The way forward

- Multi-national corporations receiving royalty and FTS income from residents in India must review their tax position and compliance in India.
- Resident taxpayers who make payments to non-residents by grossing up the withholding tax will need to review their tax costs.
- Non-residents should compare the withholding tax under tax treaties with the cost ad administrative burden of compliance in India.
- Non-residents may be able to obtain a lower withholding tax certificate from the tax authorities in India to mitigate the tax burden.

Conclusion

Since the tax rate on royalties and FTS income of non-residents in the domestic law of India is increasing, non-residents may now opt to take the benefit of lower tax rates under tax treaties. But such benefit will come with associated costs and compliance burden.

To obtain this benefit, non-residents *inter alia* will have to furnish a TRC, Form 10F and file income tax returns in India. Residents who pay royalties or FTS to non-residents will also be affected adversely – their cost will increase if they have arrangements to withhold tax after grossing up such tax with the amount of royalty and FTS paid to non-residents.

In addition, non-residents will have to examine the conditions imposed by the PPT enshrined in tax treaties and the GAAR enacted in ITA.

Accordingly, multi-national corporations receiving royalty and FTS income from residents in India should review their tax position and compliance in India. To mitigate their tax burden, non-residents may consider obtaining a lower withholding tax certificate from the Indian tax authorities.

REFERENCES

1. Section 5, Indian Income Tax Act, 1961 (ITA).
2. Sections 9(1)(vi) and 9(1)(vii), ITA.
3. For example, the India–Singapore, India–Netherlands and India–Ireland tax treaties provide for a 10% tax rate on royalty and FTS payments.
4. For example, the India–Australia, India–UK and India–USA tax treaties provide for a 15% tax rate on royalty and FTS payments.
5. Section 90(2), ITA.
6. Under section 197, ITA a non-resident can apply to the Tax Officer for a lower withholding tax certificate if their India-sourced income justifies withholding tax at a lower rate.

Morison Global

Transfer pricing in UAE – all you need to know!

CONTRIBUTED BY
Parul Jolly and **Aditi Gupta**
SCV & Co. LLP, India
E: parul.jolly@scvindia.com
E: aditi.gupta@scvindia.com

With the release of Federal Decree Law No. 47 of 2022, the Corporate Tax (CT) regime was enacted on 9th December 2022 (effective from 1st June 2023) in United Arab Emirates (UAE) by the Ministry of Finance (MoF), UAE. The said law has been designed to incorporate international business practices and to keep the compliances at a minimal level. CT rates being low at 0% & 9%, flexibility to choose the financial year, and much more, still makes UAE a leading destination for business and investment. UAE, being a member of Organisation for Economic Co-operation and Development (OECD) BEPS framework, the law includes several transfer pricing (TP) provisions that are broadly aligned with OECD principles. Thus, being a global hub, it is important for MNEs, doing business in and with UAE, to understand the nitty-gritties of UAE TP regulations, compliances and documentation requirements.

This article focuses on the TP regime in the UAE which is applicable to UAE businesses that have transactions with related parties and connected persons irrespective of whether these are located in the UAE mainland, a Free Zone or a foreign jurisdiction. The effective date of the TP regime is the same as the CT regime i.e., the financial year starting on or after 1st June 2023.

Chapter Ten (i.e. Article 34 to 36) and Article 55 of the Federal Decree Law deals with the TP provisions with regard to transactions / arrangements with related parties and connected persons which primarily provides that all such transactions / arrangements must meet the arm's length standard in determining the taxable income. The TP provisions are applicable to both domestic as well as international transactions. We shall now deal with each aspect one by one:

Arm's length principle (Article 34)

The concept of ALP is predominantly in line with the OECD's Transfer Pricing guidelines which recommends the results of the transactions between unrelated parties, as a benchmark for meeting the arm's length standard of the transactions between related parties using one or more TP method(s).

It would be noted here that the UAE law provides for benchmarking of transactions & arrangements for the purpose of determining the taxable income. Thus, if a transaction does not have a bearing on the income, it appears to be outside the purview of TP (like transaction of issue of shares). Furthermore, the list of transactions has also not been defined in the present law. While reference regarding this could be taken from OECD TP Guidelines, however, the fact that no definition has been provided, the same could result in litigation in future as to whether a particular transaction is covered within the ambit of TP provisions or not.

Transfer pricing benchmarking method and analysis

The transfer pricing methods for determination of arms length price prescribed under para 3 of Article 34 of CT law are in line with OECD TP Guidelines. The 5 widely recognised benchmarking methods for determining ALP are as under:

Building Better Business Globally

Traditional transaction methods	Explanation
Comparable uncontrolled price (CUP) method	Compares the price charged for property or services transferred in the controlled transaction to the amount charged for the property or service in a comparable uncontrolled transaction and requires very high comparability standards.
Resale price method (RPM)	Applicable in cases involving the purchase and resale of tangible goods/services. This method is preferable where there is little, or no value added by the reseller prior to the resale of the products/ services so acquired from the associated enterprise. As against exact product comparison, this method focusses on functional comparison.
Cost-plus method (CPM)	Generally applicable where semi-finished goods are sold between associated enterprises, where associated enterprises have concluded joint facility arrangement, long-term buy and supply arrangements or provision of service. This method also focusses on functional comparison and not product comparability
Transactional profit methods	**Explanation**
Transactional net margin method (TNMM)	TNMM Examines the net profit relative to an appropriate base (e.g.: cost, sales, asset) that a taxpayer realises from a controlled transaction. This method is more tolerant to functional differences between controlled and uncontrolled transactions
Transactional profit split method (PSM)	PSM is Applicable when both the parties make unique and valuable contribution to the controlled transaction and the operations are highly integrated. It involves division of profits between the enterprises
Note: The law doesn't define or explain what each of the above methods mean, hence, reference needs to be made to the OECD TP Guidelines.	

The UAE law also recognises use of 'Any other method' (other than the above prescribed methods) to benchmark the transaction(s)/ arrangement(s) provided the taxable person can demonstrate that none of the above methods can be applied to determine ALP and that the use of 'Any other method' satisfies the test of arm's length standard.

In determining the applicable TP method, one needs to be mindful of applying the most reliable TP method by considering detailed economic analysis (which includes taking into account the contractual terms & characteristics of the transaction / arrangement, business strategies employed by the related parties as well as economic circumstances in which the transaction or arrangement is conducted) and a detailed functional, asset, risk (FAR) analysis of the transaction/ arrangement needs to be undertaken. This would also include selection of tested party, being the one to which a transfer pricing method can be applied in the most reliable manner.

Related party and control

OECD model broadly provides that when one enterprise participates directly or indirectly in the management, control or capital of the other enterprises, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises, the said enterprises are considered as associated enterprises. OECD model uses the term 'Associated Enterprise' while UAE law has no reference of this term. Instead, as per UAE law, a 'Person' associated with a 'Taxable Person' is a 'Related Party'. While under the UAE law, the meaning ascribed to a Related Party, encompasses participation in control, however, the same seems quite specific. Briefly explained, for individuals, related party generally refers to his relatives or companies in which the individual (alone or together with his related parties) has a controlling ownership. For a company, related party generally refers to any other company in which the company (alone or together with their related parties) has a controlling ownership. Article 35(1) of the CT law provides for an exhaustive list of persons who would be considered as a Related Party of each other, which is described below:

- two natural persons are considered related parties if they are related within the fourth degree of kinship or affiliation. 4th degree relative would mean great great grandparent/ grandchild, etc. Affiliation by way of adoption / guardianship is also included for the said purpose.
- a natural person and a juridical person are considered related parties when such natural person or one or more related parties of such natural person, alone or together, directly / indirectly own atleast 50% ownership in the juridical person or directly / indirectly controls the juridical person.
- relationship between 2 or more juridical persons is considered related party where one entity alone, or together with its related parties, directly or indirectly owns 50% or greater share in, or controls, the other entity. This would also include a relationship where any person alone, or with its related parties, directly or indirectly owns 50% share or controls such two or more juridical persons.
- Relationship between a person and its permanent establishment (PE) / foreign PE
- Relationship between 2 or more partners in the same unincorporated partnership
- a person who is the trustee/ founder/ settlor/ beneficiary of a trust/ foundation and its related parties

Para 2 of Article 35 of UAE law defines 'Control' for the purposes of determination of related parties. The term "Control", means the ability of a person, whether in their own right or by agreement or otherwise to influence another person, and it includes the following:

- Ability to exercise 50% or more voting rights,
- Ability to determine the composition of 50% or more board of directors,
- Ability to receive 50% or more profit share,
- Ability to exercise significant influence over the conduct of business.

Considering a high percentage threshold i.e. 50% to qualify as a related party, there could be a challenge as regards being qualified as a related party under the UAE law viz-a-viz Associated Enterprise under

Morison Global

> *All transactions/ arrangements with related parties and connected persons must meet the arm's length standard in determining taxable income; the provisions apply to both domestic and international transactions*

the transfer pricing legislation of other countries. For example, in India, one of the conditions to quality as an Associated Enterprise is that the shareholding/ ownership (directly / indirectly) should be 26% or more in the other enterprise. Hence, while for India, a 26% to 49% shareholding may result in applicability of TP provisions, but the converse may not apply for UAE.

Payment to connected persons

Article 36 of UAE law provides that a deduction of expense, which is otherwise allowable to a taxable person, shall be deductible only if it is exclusively for the purpose of the business of such taxable person and the same shall correspond to the market value of the service provided by a connected person to such taxable person. A 'Connected Person' is a 'Person' affiliated with a 'Taxable Person' and means as under:

- owner of taxable person
- director or officer of a taxable person
- related party of the above [this is to be seen as per the definition of related party as explained above]

The restriction with regard to deductibility of expense will however, not apply to a taxable person (a) whose shares are traded on a recognised stock exchange, (b) that is subject to regulatory oversight of a competent authority in the State, (c) other person as may be determined by a Cabinet decision.

Corresponding adjustment

Para 10 of Article 34 of UAE law provides that in a case where a TP adjustment has been suo moto made by a person to its taxable income or has been so made by the authority, a corresponding adjustment is required to be made to the taxable income of the related party also. Conversely, where a foreign tax authority makes a TP adjustment to a transaction involving a UAE taxable person, then an application can be made to the authority for a corresponding adjustment to its income.

One may note here that in a case where the 2 persons (UAE company and an Indian company) are associated due to say 40% shareholding, then while these 2 persons are associated enterprises as per Indian TP Regulations, these are not related parties as per UAE law. In such a situation where Indian tax authority has made an adjustment to the taxable income of the Indian company, whether UAE authority will admit an application for corresponding adjustment to the income of the UAE company since as per UAE law it is not a related party, is not clear.

Documentation requirements

Article 55 of the UAE law governs the requirements of maintaining a TP documentation in respect of the transactions/ arrangements between related parties / connected persons. This is critical to demonstrate that the transaction / arrangement has met the arm's length standards. A person would be required to file a disclosure (with the tax return) containing the information regarding the transactions / arrangements, however, the form in which such disclosure is required, is yet to be prescribed.

The documentation is to be maintained for a period of 7 years following the end of the tax period to which they relate and needs to be submitted with 30 days or any other later date (as specified) when requested by the Authority. In addition to maintaining a TP documentation (local file), the authority would require the taxable person to maintain a master file also. Master file

Morison Global

contains information about a multinational group, including specific information on intangibles and financial activities. The threshold for maintaining both local file and master file has been prescribed vide Ministerial Decision 97 of 2023 dated 27th April 2023 whereby it has been provided that both Master file and Local file are required to be maintained by a taxable person that fulfils either of the following conditions:

- the total consolidated group revenue (of which the taxable person is a constituent company at any time during the relevant tax period) is AED 3.15 billion or more; or
- the revenue of the taxable person in the relevant tax period is AED 200 million or more

The said Decision also provides that transactions/ arrangements with certain related parties/ connected persons being a natural person or juridical person [which is a related party / connected person by virtue of being a partner in an unincorporated partnership] are not to be included in the local file provided that the parties to the transaction are acting as if they were independent of each other. The test of independence is that the transaction should be undertaken in the ordinary course of business and the parties are not exclusively or almost exclusively transacting with each other. If, however, the activities of one person in the transaction are subject to detailed instruction or to comprehensive control of the other person in the same transaction, then the persons shall not be regarded as acting as if they were independent of each other.

While the CT law provides that a person who claims 'small business relief' [as per Article 21] will not have to comply with TP documentation rules, however, the taxable person is required to include the transactions / arrangements with such a resident person (i.e., who claims small business relief and meets the conditions thereto) in the local file.

Non-applicability of TP provisions on entities of a tax group

UAE law provides for a concept of a 'Tax Group' whereby the entire group or entities within the group (comprising of UAE resident entities), represented by a parent entity, may opt to be considered as a single taxable person. While the law is as such silent as regards applicability of TP provisions on the members of a tax group, however, vide FAQ No. 103, it has been clarified that since the transactions between members of a tax group would get eliminated in the consolidation of group's financials, TP provisions are not to be complied with. However, in case a member of the group is required to otherwise compute its standalone taxable income for the purposes of utilising tax losses before joining or at the time of leaving the tax group, then TP provisions would apply.

Applicability of TP provisions on government entities and certain businesses

The law provides that certain businesses like extractive business, non-extractive natural resource business and certain entities like government entity & government controlled entity are exempt from CT. However, if such government entity carries on any business activity under a license issued by a Licensing Authority or if such government controlled entity carries any non-mandated business activity, then the transactions between such business/ non-mandated business

activities with the other activities/ mandated activities would need to comply with the TP provisions. Similarly, transactions between extractive business or non-extractive natural resource business and other business of the same person would also be subject to TP, if such 'other business' is not exempt as per UAE law.

Other important aspects

While the law and compliance are effective from 1st June 2023 and would apply from the chosen financial year, however, as per transitional provisions given under Article 61 of UAE law, the opening balance sheet needs to be prepared by the taxable person taking into consideration the ALP.

Conclusion

With the introduction of CT law, UAE has aimed to cement its position as a leading international business and investment hub, hence, tax compliances including transfer pricing compliances have become the need of the hour. In view of cross border transactions, one needs to strictly adhere to TP provisions and compliances.

While arm's length range for ascertaining ALP, as recognised by OECD also, is not defined as yet in UAE law, however a Cabinet decision could be expected on this. Country by country (CbC) reporting was already applicable to the UAE-headquartered MNE groups with 'financial reporting years' starting on or after 1st January 2019 and now master file & local file requirements have also stepped in through the UAE CT law. The Businesses in UAE are recommended to review the related party transactions and its arms' length determination to avoid any future penalties.

Israel: Hagshma Cosmi Project Management Ltd v. VAT Manager

CONTRIBUTED BY
Ariel Zitnitski
Zitnitski Weinstein & Co., Tel Aviv, Israel
E: az@zw-co.com

The court's decision is a welcome development for businesses that provide services to foreign residents and makes it clear that businesses can save on VAT costs by providing services to foreign residents

Facts of the case

In this case the District Court in Tel Aviv-Jaffa considered the question of whether services provided to foreign residents by a company located in Israel are eligible for zero-rate VAT.[1]

The appellant, Hagshma Cosmi, provides recruitment and employment services to sales attendants for sales positions in the duty-free stores at Ben Gurion Airport (Israel International airport). The services are provided to foreign manufacturers who are located outside Israel.

Position and claim of the taxpayer (appellant)

The appellant argued that the services are eligible for zero-rate VAT, as they are provided to foreign residents and do not relate to an asset located in Israel. It relied on section 30(a)(5) of the Value Added Tax Law, which provides that *"the provision of services to a foreign resident is subject to a zero-rate VAT, if the consideration for such service is part of the value of imported goods and certain additional conditions as stipulated in the VAT Law and the Value Added Tax Regulations"*. The appellant argued that the services in question are part of the value of imported goods, as they are necessary for the foreign manufacturers to import goods into Israel.

Position and arguments of the assessor (VAT)

The VAT manager argued that the services are not eligible for zero-rate VAT as they are provided in Israel and are therefore subject to the standard VAT rate. The VAT manager relied on the fact that the services are provided in Israel, and that Hagshma Cosmi did not provide any evidence that the services are necessary for the foreign manufacturers to import goods into Israel.

Decision of the court

The court upheld the appellant's argument and found that the services are eligible for zero-rate VAT. It found that the services are provided to a foreign resident and do not relate to an asset located in Israel; and also found that the services are necessary for the foreign manufacturers to import goods into Israel.

The court's decision is significant because it clarifies the scope of the zero VAT rate for services provided to foreign residents. Its decision makes it clear that services that are necessary for the importation of goods into Israel are eligible for zero-rate VAT, even if those services are provided in Israel. This ruling is likely to have a significant impact on businesses that provide services to foreign residents, as it will allow them to save on VAT costs since foreign companies that are not registered for VAT purposes in Israel cannot claim a refund of the input VAT paid in Israel, either in Israel or abroad.

In addition to the legal analysis, the court also made some important observations about the purpose of the zero VAT rate. It noted that the purpose of this rate is to encourage the export of goods and services from Israel, and found that the services provided by Hagshma Cosmi are consistent with this purpose, as they are necessary for foreign manufacturers to import goods into Israel.

REFERENCES

1. *Hagshma Cosmi Project Management Ltd v. Value Added Tax Manager*, the District Court in Tel Aviv-Jaffa 21657-11-19

Update on Israel

CONTRIBUTED BY
Gali Gana and **Avi Cohen**
Rosenblum Holtzman & Co., Israel
E: Galig@rhcpa.co.il
E: Avi@rhcpa.co.il

Over the past few years, we have witnessed a broad global business development, in which international companies are expanding their business ties in Israel through investments, establishment of subsidiaries, representative offices etc.

To encourage the entry of foreign investors and companies, the State of Israel has created a network of incentives for both companies and individuals who move their residence to the state. At the same time, the Tax Authority has been required to regulate various aspects of such activity.

As part of this newsletter, we will review a few changes that have recently occurred in Israel's tax policy, and key points in connection with foreign residents that wish to make investments in Israel:

- new reporting requirements in connection with transfer pricing
- incorporation of a branch or subsidiary in Israel and
- incentives for foreign residents making investments in Israel, and for new immigrants.

New transfer pricing reporting requirements

1. The Israel Tax Authority requires any taxpayer who is a resident of Israel for tax purposes who carries out transactions with a 'related party' outside Israel to carry out a transfer pricing study of the prices of the transactions made within the group, and a comparison with fair market prices.

   For example: a subsidiary in Israel of an American parent company provides inter-company services to the parent company. The services constitute an 'international transaction' that requires a transfer pricing study to be conducted, to establish whether the international transaction was made under fair market prices.

2. Furthermore, any Israeli taxpayer who carries out an international transaction with a related party abroad is required to report the transaction to the Israel Tax Authority on form 1385, which must be attached as an appendix to the annual tax return.

3. In December 2022, the Israel Tax Authority published an updated form 1385, which includes a requirement to report "Is there a market research study for the date of submitting the report?"

   The main change is that a taxpayer in Israel, who carries out international transactions and does not yet have a market research study, must now indicate this on the form, and this information may be used by the Tax Authority. The taxpayer must submit the market research study (if any) within 30 days (previously 60 days).

4. New documentation requirements in connection with transfer pricing, for an Israel taxpayer who belongs to a multi-national group, as detailed below:

   A. A multi-national group with turnover, in the year preceding the reporting year, exceeding 150 million NIS (approx. €37 million) that includes an Israel taxpayer, is required to show certain information about the group in the transfer pricing study.

   B. An ultimate parent entity that is a resident of Israel, which is a multi-national group with annual turnover exceeding 3.4 billion NIS (approx. €845 million), must submit an annual online report to the Israel Tax Authority – Country by Country report ('CbC Report') in a format specified by the Authority – on the

group and its activities in each country, for each tax year.

C. Israel taxpayers that are part of a multi-national group, but are not the ultimate parent entity, are required to report to the Israel Tax Authority, in each tax year starting with the 2022 tax year, in which country the multi-national group submits its CbC report.

In conclusion – in light of the broadening of the reporting requirements relating to the transfer pricing study, as well as the shorter time for submitting transfer pricing documentation, we recommend that Israel taxpayers who carry out transactions with related parties outside Israel prepare in advance for the new reporting requirements.

Establishing a branch in Israel or a subsidiary company

Prior to opening their operations in Israel, international companies should decide whether a subsidiary or a branch of the foreign company is the appropriate incorporation in Israel.

There are number of relevant considerations in choosing whether to establish a subsidiary or a branch in Israel. The key considerations are:

Legal liability

A branch does not have any separate legal entity from its owner, even if its business/ financial activity is completely separate, as a separate activity/profit centre.

Accordingly, a foreign company operating in Israel through a branch may find itself more exposed, from a legal point of view, for the branch's activity in Israel.

Conversely, a subsidiary is a separate legal entity, whose shareholders are the foreign company. Therefore, in general, the risk borne by the foreign company is limited to the amount of its investment in the subsidiary.

Tax considerations

An Israeli company is liable for tax in Israel, on its profits, at a rate of 23% (in 2023), with the exception of companies benefiting from tax benefits under Israel's incentive laws.

Dividend distribution from a subsidiary to the foreign parent company is subject to withholding tax in accordance with the provisions of the relevant tax treaty, and the relevant tax provisions.

On the other hand, an Israeli branch of a foreign company is liable for tax in Israel, at the corporate tax rate (23% in 2023), but has no withholding tax liability in Israel where it distributes profits/dividends to the foreign company, since this is a transfer from the foreign company's account in Israel to its account abroad – within the same legal entity.

Registration, appointing a representative and opening a bank account

Both subsidiaries and branches in Israel must register with the Registrar of Companies in Israel, and appoint a representative in Israel for the tax authorities, subject to the provisions of the income tax and VAT applicable in Israel.

It is worth emphasising that it is not possible to register and open files with the tax authorities in Israel without opening a bank account in the State (this, too, applies both to a subsidiary and to a branch in Israel).

In conclusion – the decision on the type of incorporation should be examined with local consultation, while examining all consequences, future activity, the type of activity etc.

Morison Global

Incentives for foreign residents making investments in Israel, and for new immigrants

We summarise a few incentives available to foreign residents making investments in Israel:

Tax benefits for foreign investors who carry out R&D activity in Israel for foreign entities

A foreign company that establishes a subsidiary in Israel to perform R&D activity – where the R&D is for the foreign company: the intellectual property is held outside Israel – may request the Israel Innovation Authority, subject to compliance with specific conditions, to recognise the Israel subsidiary as *"a company that performs R&D activity for an international company"*. We emphasise that this relates to R&D only – not to production, nor to support for a product.

After receiving the such approval, it is possible to receive benefits such as paying a reduced corporate tax in Israel, depending on the location of the activity in Israel (priority/non-priority zone), and subject to the conditions specified by the Israel Innovation Authority and the applicable tax provisions in Israel.

Tax benefits for foreign residents making investments in Israel

Foreign residents are entitled to exemption from capital gains tax when selling securities traded on the stock exchange in Israel, and when selling shares in a private company resident in Israel. Both exemptions are subject to certain conditions, and compliance with certain tax provisions.

Tax benefits for new immigrants and people returning to reside in Israel

The State of Israel, through the Ministry of Immigration and the Israel Tax Authority, grants significant tax benefits to new immigrants and veteran returning residents, which include, among other things, exemption from tax and reporting in Israel on assets outside the State and on income generated outside the State, for a period of ten years from the date of immigration to Israel.

Certain tax benefits are given also to returning residents (who are not veteran returning residents).

In addition, new immigrants may be entitled to an exemption from customs taxes on the importation of goods, such as personal belongings, household items etc, a discount on the payment of purchase tax, and other benefits.

In summary

The State of Israel encourages foreign residents to make investments in Israel through various incentives, grants and various benefits to new immigrants and those returning to reside in Israel.

All information in this newsletter is a summary and basic information only, and should not be reviewed, in any way, as an opinion or professional advice.

Morison Global

New Spanish start-up law: the consensus law

CONTRIBUTED BY
Ignasi Contreras
Morison ACPM, Spain
E: icontreras@morisonacpm.com

After months of debate, the Spanish Congress finally approved, on 1 December 2022, the Law for the Promotion of the Startup Ecosystem, known as the 'Start-up Law', which aims to establish a specific regulatory framework to support the creation and growth of start-up companies. It was published in the *Official State Bulletin* (BOE) on 28 December.

Although the measures adopted in the new Law came into force the day after its publication in the BOE, i.e. 29 December 2022, the most significant tax and administrative changes did not apply until 1 January 2023.

The new Law aims to promote innovative entrepreneurship to attract resources and talent encompassed within the government's Recovery, Transformation and Resilience Plan, and the Digital Spain 2025 Agenda.

The new Law defines 'emerging' or 'start-up' companies as those that develop an innovative entrepreneurship project with a scalable business model and meet conditions such as having operated for no more than five years (seven for strategic sectors), having their registered office or permanent address in Spain, and not being listed on a regulated market or distributing dividends. Likewise, companies with 60% of their workforce under employment contracts and with an annual turnover of less than €10 million in Spain will also be able to benefit from the new tax incentives.

The National Innovation Company (ENISA), which reports to the Ministry of Industry, will be in charge of approving emerging/ start-up status.

Main points

- ***Corporate income tax rate reduced*** to 15% for a maximum of four years, starting from the first period in which the taxable base is positive and up to the following three years. Moreover, all eligible companies may defer payment of tax incurred during the first two years of activity.
- ***Stock options given to employees:*** exempt limit increased from €12,000 to €50,000.
- ***Deduction for investing in new or recently created companies:*** increases from 30% to 50%, and maximum investment increases from €60,000 to €100,000.
- ***Specific tax treatment for carried interest:*** exemption for up to 50% of remuneration earned from successful management of venture capital entities linked to entrepreneurship, innovation and development of economic activity throughout the Spanish territory with the aim to foster the development of venture capital.
- ***Inpatriate tax regime:*** now applies to people posted to Spain who have not been resident in Spain during the five tax periods prior to the secondment (previously, ten years' non-residence was required).

  A special tax regime is proposed for *digital nomads*, and another for those who want to come to Spain to telework.
- ***Social Security contributions:*** 100% reduction for a period of three years for those start-up founders who simultaneously maintain employment as an employee.Flexibility in treasury stock regime for limited liability companies.
- ***Three-year protection from liquidation for emerging companies:*** where losses reduce their net worth to less than half of their social capital, during the three years after incorporation.
- ***Simpler process for creating companies:*** by offering free services for certain

Building Better Business Globally

notarial, registration, and other related costs and reducing administrative procedures.

The Start-up Law includes a range of tax measures, removing bureaucratic obstacles and shortening procedures, to encourage both the founding and investment in tech start-ups.

Obviously, any regulation seeking to foster and protect the creation of new companies and make them more competitive is always welcome and, although it should evolve and improve in all its aspects, this constitutes a step forward for both entrepreneurs and investors, and should attract talent to Spain.

Morison Global

News about Swiss taxes: VAT and WHT

CONTRIBUTED BY
Remo Merz and **Tatjana Späni**
Fineac Treuhand AG, Switzerland
E: remo.merz@fineac.ch
E: spaeni@fineac.ch

VAT: Switzerland increases its VAT rates

In Switzerland, VAT rates are anchored in the Federal Constitution of the Swiss Confederation, so a referendum is required for any changes. In September 2022, the Swiss voters approved the federal decree of 17 December 2021 on the additional financing of the old-age and survivors' insurance (first pillar of Swiss pension plan) through an increase in VAT. For this reason, the VAT rates will be increased as follows as of 1 January 2024:

	Until 31 December 2023	Increase	From 1 January 1
Standard tax rate	7.7%	+0.40%	8.1%
Reduced tax rate	2.5%	+0.10%	2.6%
Special tax rate	3.7%	+0.10%	3.8%

The reduced tax rate applies, for example, to:

- tap water,
- food (except alcoholic beverages),
- medication,
- newspapers, magazines and books (in electronic form or hard copy).

The special tax rate applies to accommodation services, which is defined as the provision of accommodation, including the serving of breakfast. For all other supplies, the standard tax rate applies.

Determination of the applicable tax rate

When VAT rates change, questions arise in relation to invoicing, especially in relation to the correct application of tax rates. Whatever rate applies, a claim for VAT is established at the date of invoicing or on the earlier collection of payment.

However, the applicable tax rate is determined neither by the date of invoicing nor by the date of payment, but by the date of performance of the supply of goods or services.

For this reason, supplies provided up to 31 December 2023 are to be invoiced at the previous, lower tax rates and supplies provided from 1 January 2024 at the new, higher tax rates.

Should a taxable entity issue invoices during the year 2023 for advance payments for supplies that will be rendered on or after 1 January 2024 the invoice must be issued with the new tax rate.

Cross-period supplies

In certain industries it is common to invoice supplies in advance and over a longer period of time (e.g. for service and maintenance works for lifts/machinery/computer systems etc.).

If such a contract or a subscription extends beyond 1 January 2024, the consideration for this supply must be split *pro rata temporis* between the previous and the new tax rate and recorded accordingly on the invoice. Otherwise, the entire invoiced supplies will be subject to the new tax rate.

Summary

Special attention must be paid immediately to the issuance of invoices. Employees must be instructed, and systems and invoicing templates must be adapted accordingly. Price lists and contracts must also be reviewed and adapted if necessary.

continued over

Building Better Business Globally

Withholding tax: Simplifications in the notification procedure within a group

Already entered into force as from 1 January 2023 are some simplifications in connection with the notification procedure for Swiss withholding tax purposes within national and international groups.

The notification procedure is now applicable in national and also international groups that hold at least 10% (previously 20%) of the Swiss company. For international cases, this new rule applies unless a different percentage is set by the applicable international agreement, e.g. double tax treaty, automatic exchange of information (AEoI) etc.

Also, the notification procedure is now extended to all legal entities that hold at least 10% of the Swiss company, i.e. also to foundations. Before, the procedure was limited to corporations, cooperatives, collective investment schemes and the state.

Finally, confirmation that the notification procedure applies in international relationships (via form 823, 823B or 823C) is now valid for five years. Before that, the confirmation had to be renewed in a three-year cycle.

These changes should reduce liquidity issues, both because the reduced minimum holding should mean more entities may adopt the notification procedure and also through the administrative simplifications in general.

Morison Global

IRS provides favourable guidance on mid-year PTEP distributions and the section 961 basis issue

CONTRIBUTED BY
Yan Jiang
Aprio LLP, USA
E: Yan.Jiang@aprio.com

The interaction between mid-year PTEP distributions and considerations of gain on controlled foreign corporation stock has presented challenges since the passage of the Tax Cuts and Jobs Act. However, new guidance from the IRS could bring more favourable outcomes for taxpayers

At a glance

The main takeaway: The IRS has provided guidance regarding basis adjustment rules under section 961 and mid-year PTEP distributions. The guidance may provide helpful perspective for taxpayers that do not have sufficient basis in controlled foreign corporation stock to avoid recognising gain on a mid-year PTEP distribution.

Impact on your business: The guidance, which was released in a private letter ruling and an advice memorandum, is not binding, but it is still beneficial for taxpayers to understand the IRS's viewpoint – especially since the issue has become more prevalent since the passage of the Tax Cuts and Jobs Act.

Next steps: Aprio's International Tax team can help multi-national companies facing this issue better understand the IRS's taxpayer-favourable viewpoint, while providing additional tax guidance on their unique situation.

The full story

The Internal Revenue Service (IRS) has recently provided advice regarding the interaction of the basis adjustment rules under section 961 and distributions of previously taxed earnings and profits (PTEP) by a controlled foreign corporation (CFC) that occur before the last day of its tax year. Taxpayers may confront this issue when they do not have sufficient basis in CFC stock to avoid recognising gain on a mid-year distribution of PTEP.

In Private Letter Ruling (PLR) 202304008 and Advice Memorandum (AM) 2023-002, the IRS concluded that section 961(a) basis increases arising from foreign income inclusions must be taken into account to determine if gain must be recognised on a mid-year CFC PTEP distribution.

The PLR and AM are not binding guidance, but nonetheless it is helpful for multi-national companies to understand the IRS's taxpayer-favourable view, which I will explain in this article.

Background on sections 959 and 961

When CFC income has had to be included in a US shareholder's income (under e.g. sections 951(a) and 951A), section 959 provides that a distribution of those earnings is not subject to US federal income tax (i.e. avoids double taxation).

In general, section 961 provides CFC-stock basis adjustment rules for US shareholders:

1. the CFC stock basis increases when CFC income is included for a US shareholder.[1]
2. the CFC stock basis reduces when PTEP are distributed by a CFC.[2]
3. gain is recognised if a CFC PTEP distribution exceeds the adjusted basis of the CFC stock.[3]

Treasury Regulation 1.961-1(a) provides guidance on the timing of a basis increase: it occurs as of the last day in the taxable year of such corporation on which it is a CFC. In contrast, Treasury Regulation 1.961-2(a)(1) provides that any basis decrease occurs at the time the US shareholder receives the PTEP distribution, and the timing of any gain recognition is not addressed. Understanding how these rules interact is crucial in cases where taxpayers need the basis increase to avoid recognising a gain on mid-year PTEP distributions.

What guidance is included in PLR 202304008?

In this ruling, the IRS dealt with a scenario involving a US corporation that owned a CFC and received a mid-year distribution

Building Better Business Globally

of PTEP. The US corporation had inclusions under section 951(a) and 951A, which gave rise to PTEP under section 959 and a corresponding basis increase under section 961(a). The issue at hand was whether the taxpayer could utilise the section 961(a) basis increase at the time of the mid-year distribution to avoid gain recognition.

In its ruling, the IRS permitted the basis increase under section 961(a) to be utilised in determining the tax consequence of the PTEP distribution occurring earlier in the tax year.

What guidance is included in AM 2023-002?

Similarly, in this memorandum the IRS analysed a fact pattern involving a mid-year PTEP distribution and provided insight into how and why the rules should operate in a manner that permits the section 961(a) basis increase to be considered when determining whether any gain is recognised.

The facts were that a domestic corporation (USP) wholly owned a CFC. Prior to Year 1, USP's adjusted basis in its CFC stock and PTEP account were both zero. In Year 1, $100 of CFC foreign income was included in USP's revenue and it increased its PTEP account by this amount. On 30 June of Year 1, the CFC distributed $100 to USP, which was excluded from USP's gross income and reduced its PTEP account.

In the AM, the IRS concluded that for the purposes of determining gain recognition on the $100 PTEP distribution, USP's adjusted basis in its CFC stock was $100. Accordingly, USP does not recognise gain because of the PTEP distribution. The IRS acknowledged that section 961 does not specifically address a mid-year distribution scenario and the timing rules could be read to conclude that, for the purposes of determining gain recognition, the adjusted basis of USP's CFC stock should be computed before or after taking into account the $100 increase. Since final PTEP can only be determined at the end of the taxable year, the IRS felt that the better interpretation was to take into account an increase in the CFC stock basis when determining gain recognition on the mid-year distribution.

Further, because sections 959 and 961 are companions designed to prevent double taxation, requiring gain recognition if the PTEP is distributed earlier would defeat their purpose. Otherwise, in this type of scenario, PTEP could only be distributed on or after the last day of the CFC's taxable year.

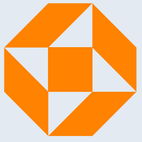
The bottom line

The IRS's approach in the PLR and AM is favourable to taxpayers who have mid-year PTEP distributions from a CFC and require an upward CFC stock basis adjustment for current-year inclusions to avoid recognising gain on the PTEP distribution itself.

While the guidance is not binding, and taxpayers cannot rely on PLRs, it does provide a clearer understanding of the IRS's position on the issue, as it should be applied by the IRS within taxpayer audits.

If you have any questions regarding the IRS's guidance or your specific tax situation, contact Aprio's International Tax team today.

REFERENCES
1. Section 961(a).
2. Section 961(b)(1).
3. Section 961(b)(2).



Morison Global

The Next Step

Contact Morison Global to discuss your needs

E: info@morisonglobal.com

T: +44 (0)20 7638 4005

www.morisonglobal.com

Morison Global

6th Floor
2 Kingdom Street
Paddington
London, W2 6BD
United Kingdom

Disclaimer: Morison global is an association of independent professional firms. Professional services are provided by individual member firms. Morison Global does not provide professional services in its own right. No member firm is liable for the acts or omissions of any other member firm arising from its membership of Morison Global.

The views expressed in this newsletter are not those of Morison Global and are not a substitute for professional advice. Before taking any decision based on the content of this newsletter readers are advised to consult their tax advisor. Whilst every endeavour has been made to ensure the accuracy of the information contained in this booklet, no responsibility is accepted for its accuracy and completeness.

Building Better
Business Globally