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Global Tax Alert

News from Transfer Pricing

Israel's Tax Authority releases circulars on transfer pricing methods and profitability ranges in certain local transactions

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Executive summary

On 5 September 2018, the Israeli Tax Authority (ITA) finalized two circulars on transfer pricing (TP). The final circulars feature a few changes to the earlier drafts published at the end of last year, the most significant being the explicit inclusion of stock options in the cost base for a markup on total costs model. One of the circulars focuses on appropriate TP methods relating to distribution, marketing, and sales by multinational enterprises (MNEs) in the Israeli market, while the other focuses on specific profitability ranges for certain transactions. The circulars provide the ITA's position regarding methodology and profitability of various types of transactions, while facilitating documentation and reporting requirements.

Multinationals with operations in Israel should review these circulars and examine their level of compliance with the ITA's positions on methodology and profitability. Those with TP strategies not in line with the ITA's positions should consider either aligning themselves with the ITA or managing the risks involved, including the impact on the tax provision.

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Detailed discussion

Circular on TP methodology

In this circular, the ITA describes its position regarding the means to identify and analyze the TP methods most appropriate for distribution, marketing and sales (including pre-sales) activities in Israel.

The ITA emphasizes that when an analysis of functions, assets, and risks (FAR) indicates sales activity that is performed without significant marketing intangibles, the most appropriate transfer pricing method according to the ITA is the Comparable Profits Method (CPM)/Transactional Net Margin Method (TNMM), with a profit level indicator based on revenue from sales in the local market.

In cases where the FAR analysis indicates marketing and advertising activities have taken place rather than sales activities, the most appropriate TP method according to the ITA is the CPM/TNMM with a profit level indicator based on operational costs.

The ITA clarifies that this circular cannot be interpreted as denying the existence of permanent establishments (PEs) of MNEs in Israel, and does not address the existence of such PE. In addition, this circular does not apply to digital activity of e-commerce and services via the internet (the "Digital Economy"[1]).

The following TP methods are described in the circular: Comparable uncontrolled price (CUP) method, Cost plus method, Resale price method, CPM/TNMM, and Profit split method.

The circular states that a FAR analysis should begin with the contract between the parties, but the contract cannot be accepted as true until it is verified that the parties' actual behavior is aligned with the terms of the contract. Further, in order to determine the nature of the local entity, it is not sufficient to identify who is the signatory to the transaction, but rather who conducted the sales activity in practice, who established the conditions of the transaction, and who solicited and generated the demand by direct contact with specific clients, as opposed to broad marketing activity to the general public. As per the arm's-length principle, the extent of the local entity's FAR should be proportional to its share of the return from operations.

The circular presents a list of criteria for the division of activity and responsibility between the local entity and its MNE affiliates.

The ITA presents a summary table illustrating the most appropriate TP methods for common sales and marketing models, along with their definitions: full-fledged distribution, low-risk distribution, and marketing activity.

Circular on profitability ranges

In this circular, the ITA presents a list of appropriate profitability ranges for certain transactions, as follows.

Low value-added services

For low value-added services that meet the criteria listed in the circular, the ITA adopts Chapter 7 of the Organization for Economic Co-operation and Development (OECD) Guidelines,[2] which establishes a markup of 5% on total operating expenses, including expenses that should be recorded according to Generally Accepted Accounting Principles (GAAP), such as stock options.

Marketing services

For marketing services as specified in section 4.3 of the circular, the ITA adopts a markup between 10%- 12% on total operating expenses, including expenses that should be recorded according to GAAP, such as stock options.

Distribution

For low-risk distribution activities as specified in section 4.2 of the circular, the ITA adopts an operating margin between 3%- 4% of total revenues generated in the relevant markets by the Israeli entity.

Alleviation in reporting requirements

Multinationals that choose to adopt the ITA's profitability ranges do not have to prepare benchmark analyses for these types of transactions, but still need to prepare TP documentation, including an economic and FAR analysis. The documentation should conclude that each transaction is conducted and priced according to the ITA's position and hence no benchmark analysis was conducted.

Advance approval can be requested from the ITA's TP department for meeting the conditions and requirements.

Implications

The circulars should be read together, along with the ITA's third draft circular on business restructuring.[3] These circulars serve as an indication of high scrutiny by the ITA of MNEs operating in Israel and their activity with respect to the Israeli market. The publication of these circulars emphasize that transfer pricing methodology and pricing is a key focus of the ITA.

Multinationals with operations in Israel should examine their level of alignment with the ITA's positions. They should also consider taking advantage of the relief in reporting requirements as provided by the ITA, by adopting the ITA's profitability ranges instead of preparing benchmark analyses for certain types of transactions. Multinationals with TP models and strategies that are not in line with the ITA should consider either aligning themselves or managing the risks involved with non-compliance, including the impact on the tax provision.

Endnotes

1. As defined in tax circular 4/2016, see EY Global Tax Alert, *Israeli Tax Authorities publish official circular on internet activity of foreign companies in Israel*, dated 15 April 2016.
2. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2017.
3. See EY Global Tax Alert, *Israel's Tax Authority releases draft circular for comments on business restructuring in multinational groups*, dated 1 February 2018.

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