September 5, 2018

Income Tax Circular No. 11/2018 – Tax Authority
Subject: <u>Determination of the appropriate transfer pricing method for activity related to distribution, marketing and sales of a multinational group within the local market</u>

<u>Contents:</u>

1. General

This circular discusses the issue of **activity related to sales, marketing and distribution** of a multinational group performed by means of an entity[1] in Israel **(hereinafter: "the local representative**").

The purpose of the circular is to specify the method for identifying and analyzing the activity and the most appropriate transfer pricing method for determining the share of the local representative from the total business activity of the multinational group, this on the basis of experience accumulated over the years in examining studies of market conditions that were submitted to the transfer pricing department and while applying the guidelines of the OECD on the matter.

The share of the local representative will be determined after performing a functional analysis of the activity carried out in Israel and applying the transfer pricing method that is appropriate for determining the market price, in order to determine the price and terms of the transactions with the multinational group. This according to that stated in Section 85A of the Income Tax Ordinance (New Version) – 1961 and Income Tax Regulations (Determination of Market Conditions) – 2006 (hereinafter: "**the Regulations**") promulgated under it.

It is emphasized that generally and subject to that stated hereunder, insofar as the analysis of the functions, assets and risks (hereinafter: "**the FAR analysis**") indicates that selling activity is being carried out and the local representative does not have material marketing intangible assets, the appropriate transfer pricing method will be the **"profitability rate method" and a profitability indicator based on the sales in the market under the responsibility of the local entity.**

In cases that the FAR analysis concludes that marketing and advertising activity is being carried out, the appropriate transfer pricing method will be the **"profitability rate method" and a profitability indicator based on the component of the costs involved in the activity itself.**

This should be qualified by noting that this circular does not negate the existence of a permanent establishment for foreign companies of the group in appropriate circumstances, including all the resulting tax consequences, and that this circular does not address the issue of existence of a permanent establishment. Furthermore, this circular does not apply to economic activity of commerce and services provided via the internet (hereinafter: "**digital economy**")[2].

[1] A body of persons, including a business unit of a body of persons for which separate accounting reports are prepared.
[2] Per its definition in circular 4/2016 on the activity of foreign entities in Israel via the internet.

2. Transfer pricing methods:

Selection of a transfer pricing method aims at finding the most appropriate method for the transaction being examined. Appropriateness of the method is examined in view of the transaction's nature which is determined by means of a FAR analysis, the availability of reliable information necessary for applying the selected method and how much it can be compared to similar transactions including adjustments that can be made in order to eliminate material differences and so forth.

Presented hereunder is a general review of part of the transfer pricing methods for determining market conditions according to various situations of operation between parties that have special relationships.[3]

2.1 Price comparison method:[4]

A method that compares the price that was set in the international transaction to the price that was set in a similar transaction.

In order to use this method, the compared features have to be almost completely identical so that there are no real differences between the transaction being examined and the comparable transaction that may affect the price on the free market.

This method can also be used when there are certain differences between the transaction being examined and the compared transactions, if the differences have been identified, they are minimal and their effect has been neutralized.

This method is the most direct and reliable method if similar transactions are found that meet the strict criteria of this method.

2.2 Profitability rate comparison method:[5]

A method that compares the profitability rate of the international transaction to that of a similar transaction with respect to a certain indicator.

The profitability rate method is divided into three different methods:

2.2.1 A method that determines the transaction's price as a fixed profit rate that is added to the direct costs:[6]

According to this method, in order to determine the market price of the transaction under examination, an accepted profit rate should be added to the costs incurred by the supplier of the product or service, in view of the functions that are carried out and the market conditions in which they are carried out, while taking into account the risks the supplier assumed and the assets it used.

This method can be suitable for semi-completed products sold between related parties, when the related parties have agreed on long-term purchase and supply agreements or when the transaction under examination is the supply of services.

In order to use this method, the compared features have to be similar, so that there are no differences between the transaction being examined and the comparable transaction that can affect the mark-up to the costs of the transaction on the free market. This method can be used also when there are differences, if the differences have been identified and their effect has been reasonably neutralized.

[3] Transfer pricing methods are described in Regulation 2 of the Regulations and in Circular 3/2008, for each method we added a translation of the appropriate terms in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017"). **Insofar as there is any discrepancy between the definitions, the definitions in the Regulations govern.**

[4] Regulation 2(A)(1) of the Regulations that is similar to the CUP method in the OECD guidelines.

[5] Regulation 2(A)(2)(a) of the Regulations.

[6] Method (1) of the "profitability rate" definition in the Regulations that corresponds to the cost plus method in the OECD guidelines.

When examining comparableness under this method, less similarities are required than in the price comparison method and the products sold or services rendered do not have to be almost completely the same, since these have less effect on the profit made by the party acting as a supplier or service provider.

In order to determine the accepted mark-up on costs, an examination should be made of the mark-up in similar transactions of the entity with unrelated parties, in the area of activity in which this method is customarily used, and if no such transactions can be found, the mark-up on costs can be searched for in transactions with similar characteristics of other entities.

2.2.2 The fixed rate of sales gross profit rate method:[7]

According to this method, in order to determine the price of the inventory purchased from a related party, an accepted gross profit rate is deducted from the resale price to a third party so that the selling expenses are covered as well as other operating expenses, and an accepted profit is left for the functions carried out (while taking into account the risks assumed and the assets used).

This method is appropriate for those cases where the seller does not add any material value to the inventory by making changes before resale to a third party. This method is not customarily used when an intangible asset makes a material contribution to completing production by the distributor who sells it to a third party.

In order to use this method, it should be examined that there are no differences between the transaction under examination and the comparable transaction that may affect the resale price margin on the free market. This method can also be used when there are differences, if the differences have been identified and their effect has been reasonably neutralized.

When examining comparableness under this method, less similarities are required than in the price comparison method as to similarity of the products being sold (there can be minor differences between the products) since the effect on the gross profit rate is lower than the effect on price. Even so, the products have to be similar enough so as to have a similar gross profit rate.

In order to determine the accepted gross profit, an examination should be made of the entity's gross profit on similar transactions with unrelated parties, in the area of activity that customarily uses this method, and if no such transactions can be found, the gross profit rate can be searched for in transactions with similar characteristics of a different entity.

2.2.3 The profitability rate method according to profitability indicators[8] such as: costs, turnover, assets and so forth:

According to this method, the similar transactions will be determined by **analyzing profitability** of companies engaged in activity similar to the activity under examination.

[7] Method (2) of the "profitability rate" definition in the Regulations that corresponds to the resale price method in the OECD guidelines.

[8] Method (3) of the "profitability rate" definition in the Regulations that corresponds to the TNMM in the OECD guidelines.

The appropriate profitability will be derived from financial ratios that will analyze profitability based on **financial statements** of the similar companies.

The difference between this method and the method of adding to the direct costs a fixed profit rate or the fixed rate of sales gross profit rate method, is reflected in the manner of identifying and finding similar transactions. As aforesaid, this method examines profitability indicators based on the financial statements of similar companies.

Examples[9] for determining the profitability indicator that is appropriate for this method:

- Operating profit to sales ratio may be appropriate for the purchase of products from a related party and their resale to a third party.
- Operating profit to costs ratio may be appropriate for rendering services or production in a non-intensive asset environment.
- Operating profit to assets ratio may be appropriate for asset-intensive production activities or asset-intensive financial activities.
- Gross profit rate to operating expenses ratio (Berry Ratio) may be appropriate when it is difficult to identify the sales and cost of sales.

2.3 Profit split method[10]:

This method tries to determine how the profit expected from the transaction by unrelated parties will be split according to the value of their contribution. According to this method, the overall profit from the transaction is identified and then split between the various entities that are partners to the transaction under examination on an appropriate economic basis.

Examples of advantages when applying this method:

- This method provides a solution to cases in which the parties to the transaction make a special and significant contribution to the transaction.
- This method provides a solution to cases in which the transactions are interrelated so that a one-sided method would not provide an appropriate solution.
- The method allows flexibility in that it can take into consideration actions and facts that are unique to the multinational group and cannot be found in similar transactions.

Examples of disadvantages when applying this method:

- The need to obtain comprehensive and extensive information on both parties to the transaction.
- The need for uniformity of reporting between the parties in order to determine the overall profitability of the transaction.
- The need for a correct split between the examined area of activity and the other areas of activity of both entities, assuming they engage in other activities.
- Difficulty in quantifying relative contribution.

3. Selling, marketing and distribution activity as part of the company's total activity:

In every business activity, the sales function, including the presale process, is a material and important component. An expression of this is seen when comparing the salary of the salespersons to the salary of those carrying out other functions in the business group such as collection or ordering products. Without the selling function, sales are not expected to produce a considerable profit.

[9] These are not binding examples, other indicators may be chosen according to circumstances.
[10] Regulation 2(A)(2)(b) of the Regulations that is similar to the profit split method in the OECD guidelines.

The selling function includes, inter alia: means for selling the merchandise or service, creating and retaining customer relations, efforts and strategy for attracting new customers, and so forth. The presale function includes, inter alia: market penetration, contacting regulators, initiating selling activity, identifying relevant customers, and so forth.

Insofar as the local representative constitutes an integral part of the selling process, the pricing of that representative will be derived from its objective – the sales themselves. If its activity is not an integral part of the selling process, its pricing will be derived from a different indicator.

The functional analysis should start with an analysis of the contract between the parties, but will not end with this. It should be examined whether the actual conduct of the parties agrees with that stated in the contracts, and that stated in the contracts should not be accepted as an irrefutable truth.

For purposes of transfer pricing in general and for the purpose of determining the activity of the local representative in particular, it will not be enough to identify who signs the transaction. It will have to be examined **who actually carried out the selling activity**, who determined the terms of the transaction, who worked on soliciting and creating demand on the part of specific customers as a result of direct contacts with them and not as a result of wide-spread marketing activity directed at the general population.

According to the arm's length principle[11] that states that the terms of a transaction between related parties are best examined by comparing the terms of a transaction between related parties to the terms of a similar transaction between unrelated parties, insofar as the functions, assets and risks of the local representative are more limited, thus its share of the profit expected from the activity will be lower and vice versa.

<u>Performing an FAR analysis:</u>
Distribution of the activity and responsibility between the local representative and entities of the multinational group (hereinafter: "**the managing entity**") should be examined according to, inter alia, the following criteria:

- The terms of the contract between the parties.
- The actual conduct of the parties to the contract.
- Where are the contracts related to the transaction signed and by whom.
- What is the responsibility of the local representative and what is the responsibility of the managing entity, for example:
  - Presentation of the product to the customer.
  - Advertising to the general population.
  - Characterization of the customer's needs.
  - Negotiating the contract:
    - Specifying the prices before the customer.
    - Approving discounts.
    - Approving extraordinary credit terms.
- Is there any other entity, on the local market, that exclusively markets the products or services and is not a related party. Does the entity only provide logistics services.
- Who is responsible for the sales in the eyes of the customers.
- What is the complexity of the sold product.
- Who performs customer integration at customers.
- The number of employees of the local entity compared to sales revenue.

[11] For expansion on this matter see Paragraph 2.1 of Circular 3/2008 regarding transfer pricing and Paragraph 2 of Circular 12/2018 regarding profitability rates and ranges for certain transactions.

- The employee compensation method – are the employees compensated, inter alia, according to a percentage from sales.
- What are the risks of the transaction and who actually bears them.
- Which assets are used in the transaction and to whom do they belong.

As aforesaid, it is very important to identify the transaction and determine a profitability method and indicator that are appropriate for the transaction and to set clear rules on how to act.

In the business world in general and in the world of multinational enterprises in particular there are various models for activity related to sales. This circular describes accepted transfer pricing methods that apply to accepted models of engagement between parties that have special relationships with respect to sales, marketing and distribution.

It is noted that the price comparison method is not commonly used since that method requires almost complete identity between the compared features as specified in Paragraph 2.1 of this circular and accordingly is a difficult method to apply. Therefore, this method is not included in the models described hereunder. Nonetheless, transfer pricing regulations and the hierarchy described therein govern and therefore **when the price comparison method can be applied, it should be selected since it represents the most reliable comparison that appropriately represents market price.**

4. Examples of sales models and the pricing method

4.1 Full-fledged distributor:

The principal characteristics of an entity that is a full-fledged distributor are, inter alia:

- It bears the principal responsibility in the transaction and not the manufacturer. It is responsible towards and vis-à-vis the customer, including usually to supply the product including representations made over the course of marketing and determining the selling terms which make it responsible.
- It bears the inventory risk, a risk that usually exists when inventory is ordered before being sold to the customer, or the entity is responsible for product returns. It bears the risk of physical loss of inventory.
- It has a reasonable range of action under economic restrictions to set the price of the transaction.
- It can determine the supplier of the product or service.
- It is involved in the product or service characterization process at the customer.
- It bears the customer credit risk.

Many functions are characteristic of a full-fledged distributor and include functions that are described hereunder regarding a low risk distributor. It is noted that insofar as the local entity has more risks, the activity will be more that of a full-fledged distributor.

According to such criteria, a full-fledged distributor assumes all the principal functions and risks involved in the sales process. Also in cases where not all the characteristics exist, but only most of them, it can still be said that the entity is a full-fledged distributor and its activity be priced accordingly.

In the case of an entity that has such activity, the pricing for transfer pricing purposes should be derived from the sales it creates and reflect the broad functions and risks it assumes, and a method based only on profitability on operating costs may not be used.

The accepted pricing methods will usually be:

a. **The fixed rate of sales gross profit rate method of Paragraph 2.2.2 or the comparison of profitability with a profitability indicator deriving from sales method of Paragraph 2.2.3.**

b. **The profit split method of Paragraph 2.3 (for example in cases where the local representative has material intangible assets).**

4.2 Low-risk distributor:

The principal characteristic of a distribution company, of selling merchandise to customers, exists also in the case of a low-risk distributor.

A local representative that operates according to this model, is similar to a local representative that operates according to a full-fledged distributor model, but operates with lesser risks.

The principal characteristics of an entity engaged in such activity are, inter alia:

- Selling activity to domestic customers – Presenting the product to potential customers, its customization for the customer, notifying the customers on developments in the product (like updates) and so forth.
- Ownership over the inventory is sometimes transferred to the low-risk distributor which may also possibly bear the customer credit risk.
- Sometimes there is a contract between the said local entity and the managing entity by which the managing entity will compensate the low-risk distributor for various costs and various risks and functions will be transferred to the managing entity.
- The low-risk distributor has risks regarding collection and inventory but will be compensated for these by the managing entity if necessary, for example compensation by the managing entity for bad debts, and selling back to the managing entity slow-moving or obsolete inventory at cost.
- A large number of customers relative to the local market – nevertheless it is emphasized that in certain cases it is possible that only a few potential customers constitute the entire local market.
- Understanding of the customer's needs, the local entity constructs the transaction and executes the sale.
- Customer retention activity.
- Occasional involvement in negotiations with the customers (even if the agreement is not ultimately signed by the local representative).
- Is regularly up-to-date on the situation of the inventory. This can be either by management of the inventory on the books or by means of joint systems or by receiving regular updates from an unrelated local company that provides distribution, storage or logistics services (hereinafter: "**local distributor**").
- Work management with a local supplier of logistics services.
- Employees involved in sales are among the highest paid employees of the entity carrying out the activity.
- The employees have expertise in the area of the sales activity.
- The local entity is a representative of the multinational group on the local market.
- The marketing strategy and related expenses will be paid and decided by the managing entity.
- Invoices can be issued by a local distributor as defined above.

In the case of an entity that has such activity, the pricing for transfer pricing purposes should be derived from the sales it creates and reflect the broad functions and lower risks

it assumes. The lower risk should be reflected in the company's profitability rate, a method based only on profitability on operating costs may not be used.

The accepted pricing method will usually be the comparison of profitability with a profitability indicator deriving from sales method of Paragraph 2.2.3.

The profit rate that will be determined as operating profit divided by sales will be affected by the extent of the functions, assets and risks.

4.3 Marketing activity:

An entity that carries out marketing activity is one that executes, inter alia, advertising, market research and economic analyses related to sales.

The principal characteristics of an entity engaged in such activity are:

- Small number of customers on the local market (**not cases of "partners" to bids and the like** or of an initially limited market), the customers do not consider the local representative to be responsible for any problems.
- The local representative has a small number of employees.
- The employees of the local representative are not compensated on the basis of sales in the territory.
- The employees are not professional enough to help sales in this area in view of the product's complexity. Their job is only to create contacts between employees of the managing entity, which has people with skills to execute the selling activity, and the customers.
- The salary of the "salespersons" of the local representative is lower compared to the market in which the local representative operates in a way that shows their lack of value to the selling process.
- The activity of the local entity is more characterized by advertising activity, performing market research, market segmentation and so forth.
- There is a different official distributor on the local market and the local representative only "sells" to the official distributor – it should be noted that this is not a "local distributor" as defined in Paragraph 4.2 of this circular. As aforesaid a "local distributor" actually provides logistics services and does not perform marketing on behalf of the group.

Under this model the entity only carries out marketing activity. The local representative that operates according to this model should determine its profitability on the basis of an indicator deriving from the costs involved in the marketing activity.
The pricing will usually be determined according to the method that determines the transaction's price as a fixed profit rate that is added to the direct costs according to Paragraph 2.2.1 or the method of comparing profitability with a margin on operating costs according to Paragraph 2.2.3.

The attached table is an auxiliary tool and includes references to the circular with respect to the method of the FAR analysis, it is clarified that all the data found should be examined in order to classify the selling activity in question.

It is possible that certain functions are described as characterizing certain activity, but fit other activity as well. In those case the appropriate transfer pricing method should be determined according to the majority of the criteria that are met.

In the case of any doubt, the transfer pricing department may be contacted for obtaining a pre-ruling on the matter.

Sincerely,

The Israel Income Tax Authority

Appendix to the circular

Tables for classifying the activity carried out by the local entity and the accepted transfer pricing method:

Full-fledged distributor

Functions	Assets	Risks	Appropriate transfer pricing method according to the type of activity
Paragraph 4.1 of the circular	Inventory, employees, customer portfolio, suppliers and so forth.	The local representative is responsible for most of the risks from the distribution activity. For more information see Paragraph 4.1 of the circular.	**The fixed rate of sales gross profit rate method – Paragraph 2.2.2.** **The profitability rate deriving from sales method – Paragraph 2.2.3** **The profit split method – Paragraph 2.3**

Low-risk distributor

Functions	Assets	Risks	Appropriate transfer pricing method according to the type of activity
Paragraph 4.2 of the circular	Paragraph 4.2 of the circular	The activity is defined as low risk. Most of the risks are transferred to the managing entity.	**The profitability rate deriving from sales method – Paragraph 2.2.3**

Marketing activity

Functions	Assets	Risks	Appropriate transfer pricing method according to the type of activity
Paragraph 4.3 of the circular	Paragraph 4.3 of the circular	No risks derive from the selling activity on the local market.	**Fixed profit rate that is added to the direct costs according to Paragraph 2.2.1** **The profitability rate deriving from operating cost method – Paragraph 2.2.3**