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Income Tax Circular No. 12/2018 – Tax Authority
Subject: Transfer pricing – profitability rates and ranges for certain transactions

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1. General background

Transfer pricing deals with pricing and examining the pricing of transactions between parties that have special relationships as stated in Section 85A (hereinafter: "**related parties**") of the Income Tax Ordinance (New Version) – 1961 (hereinafter – "**the Ordinance**"). When a transaction is executed between unrelated parties, the difference in interests results in the agreed price and terms reflecting market conditions. When the transaction is between related parties, there is no such difference in interests, and it is possible that an inappropriate price or inappropriate terms will be determined for the transaction for the purpose of maximizing benefits such as erosion of the tax base (for example – by determining a price or expense that are higher than the market price for a profitable company that buys or receive a service from a losing company).

Different countries around the world have different laws in the area of transfer pricing, the law in Israel on this matter includes Section 85A of the Ordinance and Income Tax Regulations (Determination of Market Conditions) – 2006 (hereinafter: "**the Regulations**") that were promulgated under it.

The OECD published transfer pricing guidelines¹ (hereinafter: "**the Guidelines**"), the Guidelines are an interpretative source in the area of transfer pricing for tax authorities around the world and in Israel.

The purpose of this circular is to present the position of the Israel Tax Authority regarding a few types of transactions, while providing alleviation in the documentation and reporting requirements by way of a safe harbor².

This circular allows choosing to report according to the profitability rates indicated in it, which were determined based on the accumulated experience of the transfer pricing department of the Israel Tax Authority.

The profitability rates will be examined from time to time and may be adjusted accordingly.

2. The arm's length principle

A basic principle in the area of transfer pricing is the "arm's length principle" for determining market conditions between related parties. The terms of a transaction between related parties under the "arm's length principle" will be best examined by comparing the terms of a transaction between related parties to the terms of a similar transaction between unrelated parties, The arm's length principle is based on Article 9 of the OECD model tax convention:

[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

At the center of the arm's length principle there is a "**comparative analysis**", that requires finding transactions between unrelated parties that are similar to the transaction executed by the related parties. Subsequently, the price or terms of the transaction should be derived from the transactions between unrelated parties, and these will be considered market conditions according to the arm's length principle.

¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017.

² Chapter IV of Part E of the guidelines.

Applying the arm's length principle requires a process of collecting information on the business activity so as to characterize the transaction and find similar transactions. Moreover, the process requires exercising broad discretion by both the taxpayer who is choosing how to price and present the transaction and the tax authority, which has the task of auditing the reports.

Price and market conditions in Section 85A of the Ordinance coincide with the arm's length principle. The method of determining price and market conditions are specified in the Regulations.

So as to justify market conditions, the taxpayer is required to submit to the assessing officer a market conditions study as specified in Regulation 5 of the Regulations. The market conditions study and particularly that stated in Regulation 5(a)(8) is the de facto implementation of the aforesaid principles.

3. **Profitability rates and ranges suitable for certain transactions**

Presented hereunder are profitability rates and ranges that meet the market conditions and price of the following transactions:

3.1 **Low value-adding services**

Low value-adding services are defined in the Guidelines.³ These are services that meet all the following criteria:

- The services are intercompany services.
- The services have a supportive nature.
- The services are not a part of the core business of the multinational group.
- The services do not require using unique and valuable intangibles, and do not bring to the creation of unique and valuable intangibles.
- The services do not involve taking and/or controlling a risk on the part of the service provider.
- The services are not provided to unrelated parties.

Low value-adding services **are not**, inter alia:

- Research and development services.
- Manufacturing or production services.
- Purchasing raw materials associated with the manufacturing or production processes.
- Selling, marketing or distribution services.
- Financial services.
- Mining, exploration or processing of natural resources.
- Insurance services.
- Management services.

Examples of low value-adding services:

- Actions relating to human resources – such as: recruitment of employees, training new employees.
- Assistance in planning employee compensation schemes, insurance, and so forth.
- Installing, maintaining and updating an organization's computer systems (when these actions are not a part of the organization's core business).
- Legal services.
- Tax services.
- Other general services of a clerical nature.

³ Chapter VII Section D.

This circular adopts Section 7.61 of the Guidelines by which low value-adding services result in an operating profitability equal to the amount of expenses involved in their production (direct and indirect, including expenses that should have been required in accordance with generally accepted accounting principles such as employee options) multiplied by 5% (according to the profitability rate method mentioned in Regulation 2(A)(2)(a) of the Regulations and an indicator of operating profit to gross and operating costs ratio as mentioned in Paragraph 3(a) or 3(c) of the definition of profitability rate in Regulation 1).

3.2 Marketing services

- The marketing services referred to in this circular coincide with activity classified as marketing according to Section 4.3 of the circular regarding determination of the appropriate transfer pricing method for activity related to distribution, marketing and sales of a multinational group within Israel (hereinafter: "**the methods circular**").
- So as to remove any doubt, it is clarified that no unique and valuable intangible assets are being used in order to provide the services, and that the services do not bring to the creation of unique and valuable intangible assets.
- It is further clarified that the services do not involve taking and/or controlling a material risk on the part of the service provider.
- **This circular states that such marketing services will result in an operating profitability equal to the amount of the expenses involved in their production (direct and indirect, including expenses that should have been required in accordance with generally accepted accounting principles such as employee options) multiplied by a rate of 10%-12% (according to the profitability rate method mentioned in Regulation 2(A)(2)(a) of the Regulations and an indicator of operating profit to gross and operating costs ratio as mentioned in Paragraph 3(a) or 3(c) of the definition of profitability rate in Regulation 1).**

3.3 Distribution services

- The distribution services referred to in this circular coincide with the activity classified as low risk distribution according to Section 4.2 of the methods circular, and which are provided in Israel.
- So as to remove any doubt, it is clarified that no unique and valuable intangible assets are being used in order to provide the services, and that the services do not bring to the creation of unique and valuable intangible assets.
- It is further clarified that the services do not involve taking and/or controlling a material risk on the part of the low risk distributor.
- **This circular states that such distribution services will result in an operating profitability equal to the amount of the total sales turnover in the markets, in which the Israeli entity undertakes distribution activity, multiplied by 3%-4% (according to the profitability rate method mentioned in Regulation 2(A)(2)(a) of the Regulations and an indicator of operating profit to sales ratio as mentioned in Paragraph 3(a) or 3(c) of the definition of profitability rate in Regulation 1).**

4. Alleviation in reporting requirements

- **It is clarified that a taxpayer that reports according to the rates specified in this circular with respect to the aforesaid low value-adding services, marketing services and distribution services will be subject to the reporting requirements provided in Regulation 5 of the Regulations with**

respect to reporting on a market condition study, other than the requirement in Regulation 5(a)(8).

- In other words, it shall not be required to detail: "similar transactions, the comparison method selected and the comparability criteria in accordance with which the value range and inter-quarterly range were determined, as applicable, details of the adjustments that were made to the comparability criteria and explanation for the choice of the comparison and the adjustments that were made, details of the results that were obtained as a result of the comparison, presentation of the value range or inter-quarterly range, as applicable, and the conclusions derived from the comparison to the similar transactions."
- **Taxpayers that report according to rates that differ from those specified in this circular will be required to submit a full market conditions study as stated in Regulation 5.**

The transfer pricing department of the tax authority professional division may be contacted for requesting a pre-ruling on compliance of the aforesaid services with the required conditions.

Sincerely,

The Israel Income Tax Authority