Transfer Pricing Country Summary

Israel

September 2018

Legislation

Existence of Transfer Pricing Laws/Guidelines

The current legal framework in Israel is based mainly upon Section 85A ("**Section 85A**") of the Israeli Tax Ordinance. Section 85A which was enacted in 2006, introduced the arm's length principle (which was previously unofficially enforced through Section 86 of the Israeli Tax Ordinance (the section which deals with artificial transactions), by asserting that an international transaction between "parties with special relationship", i.e. related parties, should be reported to the tax asserting officer and be taxed in consistence with the appropriate market price. Guidance regarding transfer pricing is incorporated under Tax Circular 3/2008 and under the regulations promulgated under Section 85A (the "**Israeli TP Regulations**").

The regulations promulgated under Section 85A adhere to the arm's length principle and incorporate guidelines from both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "**OECD Guidelines**") and Section 482 of the US Internal Revenue Code ("**Section 482**"), towards determination of the correct analysis methods for examining an international transaction between related parties.

Applicability of Section 85A

The Israeli TP Regulations require that all cross-border transactions in which "special relationship" (see definition below) exist between the parties to the transaction be consistent with the arm's length principle and are expected to be taxed accordingly. Upon approval by the tax assessing officer (AO) granted to a taxpayer, certain one-time transactions may be excluded from the scope of the regulations; however, such approvals are rare and are limited in scope (more details can be found in the Israeli TP Regulations).

Additionally, the Israeli Tax Authorities (the "**ITA**") has recently been implementing the principles of Section 85A, unofficially, also with related-party transactions within Israel.

Definition of a Related Party

Section 85A(b) defines the term "special relationship" relating to as the relationship between an entity (including an individual) and its relative, the control of one party to a transaction over the other, or control of one individual (or entity) over the parties to the transaction, directly or indirectly, individually or jointly with others.

The term "control" is defined as "holding, directly or indirectly, 50% or more in one of the means of control". The term "means of control" include: the right to receive profits; the right to appoint directors or the general manager or other similar positions; the right to vote in the general shareholders' meeting; upon liquidation of the company, the right to a share in the equity after all debts are paid; and/or the right to determine which party will have one of the above- mentioned rights. The term "relative" means "a spouse, sibling, parents, grandparent, offspring, spouses' offspring and the spouse of each of these".

Recent Developments – Israeli Transfer Pricing Regulations

- An update regarding the operations of foreign multinationals in Israel via the internet is included in Tax Circular 4/2016. This circular, inspired by the OECD's BEPS Action Plan (BEPS) concerning the digital economy, provides guidelines and rules under which foreign companies' income derived from selling products or providing services through the internet to Israeli residents (digital activity), will be deemed the income of a permanent establishment (PE) in Israel for tax purposes in certain circumstances. The circular distinguishes between foreign enterprises that are residents of a treaty state (treaty resident companies) and foreign enterprises that are residents of a non-treaty state (non-treaty resident companies) and provides different rules for determining the attributed income to the Israeli PE for each of the aforementioned companies.

- On May 2016, Israel signed the Multilateral Competent Authority Agreement for the automatic exchange of country-by-country reports (CbCRs), which allows all participating countries to bilaterally and automatically exchange CbCRs with each other. Adoption of the CbCR may imply the ITA's intention to implement a global tax position when assessing profit attribution among companies in a multinational corporation.

- In January 2017, a proposed amendment to the Israeli Tax Ordinance that includes transfer pricing provisions, adopting anti-BEPS measures, passed the first reading (out of three required) in the Israeli parliament. The proposed legislation aligns transfer pricing documentation requirements with BEPS requirements. The proposed legislation updates the provisions of Section 85A adds sections 85B and 85C to the Israeli Tax Ordinance. The applicable effective date of the proposed legislation has not yet been determined, nor has it been finally approved.

- In August 2017, the ITA issued Circular 7/2017, which relates to loans to related parties.

- During 2018, the ITA has issued two draft circulars regarding the expected margins for distributorship activity in Israel and for local subsidiaries providing marketing services to their foreign parent or related foreign companies, however such circulars have not been officially published yet.

Recent Developments – Israeli Case Law

- A recent ruling issued by the Supreme Court on April 2018, in an appeal over three District Court' rulings, relating to the inclusion of the cost of the stock options granted by foreign parent corporations to the employees of their Israeli subsidiaries in the "cost" basis of TNMM (customarily referred to as "cost plus" arrangements) and of the recognition of expenses with regard to such stock options, upheld the resolution of the District Courts, and finally determined that such costs and expenses should be included in the cost base when implementing a "cost plus" arrangement for (in this case, R&D) services provided by the Israeli subsidiaries to their parent corporations. In Israel, this bears a significant meaning, as the Israeli Tax Ordinance allows for different tax routes when granting options to employees of an Israeli company, the most customary of which grants to the employee receiving an option both a tax postponement and a tax reduction, however the Israeli company cannot recognize the expenses associate with the options.

  This resolution also reiterated the importance of contemporaneous documentation, reversed burden of proof, and the ITA's authority to set the results of an intercompany transaction at the median in case the tax payor lacks such documentation.

General

Application of the Arm's Length Principle

Application of the arm's-length principle is generally based on a comparison of the conditions in a cross-border controlled transaction with the conditions surrounding similar transactions entered between independent companies ("comparable companies" or "uncontrolled transactions"). To determine if a cross-border controlled transaction has been carried out in accordance with the arm's length principle, the following steps need be taken:

- Identifying the cross-border controlled transactions within the group;
- Identifying the tested party for each respective transaction;
- Performing a functional analysis with special emphasis on comparability factors such as business activity, the characteristic of property or service, the contractual conditions of the cross-border transaction and the economic circumstances in which the taxpayer operates;
- Selecting the appropriate TP method(s);
- Selecting the comparable companies and establishing an arm's length range, determined by the comparable companies;
- Examining whether the tested party's results fall within the arm's length range.

According to the Israeli TP Regulations, a cross-border controlled transaction is considered to be at arm's length if, following the comparison to similar uncontrolled transactions, its results do not deviate from the results of either the full range of values, when applying the comparable uncontrolled price (CUP) method, or the results of the interquartile range (the values found between the 25th and 75th percentiles in the range of values), when applying other methods.

Transfer Pricing Scrutiny

Within the ITA is a dedicated Transfer Pricing Department (the "TPD"), which is responsible for performing audits and the economic analyses to determine the arm's length price for a tax payor's controlled transactions. The TPD audits Israeli subsidiaries of multinational enterprises (MNE), permanent establishments (PE), and local corporations with subsidiaries outside of Israel, and has been given the full authority to review (and tax) previously approved assessments, and to reopen final assessments, which were approved up to three (3) years before their inspection. The TPD also gives guidance and instructions to local tax assessment officers ("AO") to screen and initiate audits on a wider level. In case of an audit by a local tax assessment officer, certain disagreements may be handed over to the TPD.

Evidence-Gathering Process

The ITA does not usually interview persons outside the company undergoing an audit, although this is not prevented by legislation. It is common, however, that the professionals who consult the company will be able to present their findings and prepared documentation to the ITA as part of a 'hearing' held to the company. Such meetings occur both prior to and following the issuance of a transfer pricing tax assessment.

With regard to intra-group information requirements, the ITA may request such information even if such information is held outside of Israel. If the tax payor fails to present the requested information, it will most likely be negatively considered throughout the process, potentially preventing the company from providing such information at a later stage, to the ITA or in court.

Transfer Pricing Adjustments

According to the Israeli transfer pricing rules, the initial burden of proof lies with the tax payor. As such, companies not transacting at arm's length, or which do not hold the required transfer pricing documentation (proving their compliance with the arm's length principle), are exposed to penalties and change of pricing according to the ITA's discretion with a narrow arguable position, and would be required to adjust their net income to incorporate the appropriate transfer prices for their intra-group transaction. This unilateral adjustment could lead to double taxation regarding income that was taxed in other jurisdictions. A "competent authority" process is possible in certain circumstances.

In addition, the ITA is entitled to impose secondary adjustments and, in fact, does so in practice. Under audit, if the results of the cross-border controlled transaction fall outside the applicable arm's length range, the tax authorities will enforce an adjustment to the median value of the comparable results. Tax payors can dispute the proposed transfer pricing adjustments of the tax authorities by means of appeals, courts and through the use of treaties (when relevant).

Non-Recognition

In rare cases where a transaction between related parties lacks any commercial rationality (namely, the same transaction under similar economic circumstances would not have been agreed between non-related parties), the ITA may choose not to recognise the transaction in its original form, and may treat it as an entirely different type of transaction that in its view would reflect the business reality of the transaction in a more adequate manner. Such re-classification of transactions can relate, inter alia, to the treatment of inter-company loans or cash pooling or non-repayment of inter-company debts, as dividends, as well as to the ownership of intangibles. Non-recognition can cause double taxation, and, while derived from Section 85A, is based also on Section 86 of the Israeli Tax Ordinance, as mentioned above.

Settlements

Transfer pricing cases rarely reach the court in Israel, with most cases being settled in discussions with the ITA. APAs are not common in Israel, although they exist, and settlement can sometimes also be carried forward as part of an APA. However, settling a past audit cannot guarantee that the same treatment will be awarded in the future, unless an APA is reached.

Transfer Pricing Penalties

Penalties may be imposed on a tax payor for not preparing and submitting transfer pricing documentation on time or at all. The current legislation allows for 60 days from request by the ITA to present the documentation, however the AO usually ask for this to be more immediate, and suggested legislation is expected to shorten this period to 30 days. In any case, the lack of contemporaneous documentation at the time the tax returns were filed, is likely to shift the burden of proof to the tax payor, as mentioned above. There are no specific transfer pricing penalties, so regular penalties apply.

Statute of Limitations

Normally, the statute of limitations in Israel is seven (7) years, subject to certain exceptions. The statute of limitations for tax purposes is 3-4 years, however in 2015, a certain court ruling stated that although the criminal aspects of tax evading may be limited (pending the nature of the offense), the non-criminal, civil, liability may not be limited. This notion was also enacted in 2016, for certain tax offenses. For VAT purposes, the statute of limitations is 5-10 years, subject to specific instructions.

Advance Pricing Agreement (APA)

APA provisions are included under Sections 85A(d) and 158 of the Income Tax Ordinance. Both unilateral and bilateral APAs can be reached with the ITA.

While there is no specific guidance on the content of an APA application, an initial APA request shall be sent to the TPD and will include:

- the essential facts;
- transfer pricing documentation;
- relevant documents, approvals, opinions, declarations, estimates, and agreements;
- a description of the intercompany transaction(s); and
- the taxpayer's proposed consideration for the transaction(s), including the profit level margin.

No fee is charged by the ITA for an APA application.

The TPD will then respond to the taxpayer with a request for the following data:

- information regarding comparable transactions;
- information regarding the chosen TP method;
- comparability factors and details regarding any adjustments made to the comparability factors;
- the reasons for choosing the selected method;
- the results of the comparables;
- the relevant range of values or the interquartile range and any conclusions drawn from the comparison;
- financial reports of both parties to the transaction for the previous three years; and
- any document or other detail deemed necessary for the ITA decision.

The TPD will then negotiate with the taxpayer and may request more documents, meetings, and site visits. The TPD has a 120 days' timeframe within which it must approve or reject an APA application, however a 60 days' extension may be granted where notice is given to the Tax payor. If the tax authorities do not issue their decision within the time limits provided, approval of the APA will be considered to have been given and the transaction subject of the APA will be deemed to be at arm's length.

There is no specific guidance for a renewal procedure. In practice, the ITA supports APA renewals, however, the procedure is similar to the initial APA as described above.

Documentation and Disclosure Requirements

Tax Return Disclosures

Tax payors engaged in a cross-border controlled transaction/s are required to file a compliance form annexed to its annual general tax report submitted to the ITA ("Form 1385"). Form 1385 requires a general description and details of the tax payor's intercompany transactions (such as the volume of the transactions, transaction type, terms and conditions, and the parties thereto) and the declaring that the transactions are conducted in compliance with the arm's length principle as stipulated in Section 85A.

The form must be signed by an officer of the company (usually the company's chief financial officer), as an affidavit, thereby constituting not only the liability of the company, but also the personal liability of the signing officer. Form 1385 is in fact a legal deposition and poses a certain dilemma to an officer of a non-compliant company – if she signs the form knowing that the company is non-compliant, she may be held accountable for perjury, and in case the form is left unsigned or unfiled, the ITA is alerted to the fact that the tax payor may not comply with the arm's length principle. Although no personal or criminal liability has yet been claimed by the ITA in cases where the form was inaccurate, the ITA is debating internally on this matter.

Level of Documentation

A tax payor engaged in a cross-border controlled transaction is required to include in its annual tax return the foregoing mentioned Form 1385 describing the intercompany transaction and its nature, including references to its price and other relevant terms and conditions. Hence, the ta payor is expected to hold contemporaneous documentation, updated on an annual basis.

Since, as noted above, by signing Form 1385 the taxpayer declares that the company is compliant with the arm's length principle and that it maintains up-to-date transfer pricing documentation (i.e., transfer pricing study, inter-company agreement and also, where applicable, a transfer pricing policy), it is advisable to have in place an updated transfer pricing study on an annual basis. In addition to preventing penalties and fines, holding a transfer pricing study and other related transfer pricing documentation shifts the burden of proof to the tax AO and enables the tax payor to hold an arguable position regarding any determination made by the tax AO concerning transfer pricing adjustments.

Full documentation includes the following:

- Description of the principle inter-company transactions and the parties involved in these transactions, including a description of the management structure of the parties and functional organizational charts;
- Description of the business environment and the economic circumstances in which the parties operate;
- Functional analysis of the parties involved in the intercompany transactions (including functions performed, risks assumed and resources employed);
- Selection of the pricing method(s) and the reasons behind such selection;
- Economic analysis (determination of arm's length prices);
- The conclusions that may be derived from the comparison to uncontrolled comparable transactions.

Additional documents that corroborate the data described above such as:

- intercompany agreements;

- any disclosure made regarding the controlled transactions to any foreign tax authority including any request for an advanced pricing agreement (APA);
- a transfer pricing policy, if applicable;
- any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns; and
- any existing opinions by the company's consultants, if such were given.

Recent Developments – TP Documentation

On January 4, 2017, a proposed legislation which amends the ITO, including new transfer pricing provisions with respect to BEPS Action 13, passed the first reading (out of three) in the Israeli parliament. The proposed legislation updates the provisions of Section 85A of the ITO and adds sections 85B and 85C to the ITO. The applicable effective date of the proposed legislation has not yet been determined. Consequently, there is no current requirements by the ITA for a Master File, however in certain audits it is expected that the company would hold one.

When the amended legislation will be approved, in addition to the regular local file (i.e., the transfer pricing study) Israeli tax payors that are part of a multinational group will also be required to submit data at the corporate level, namely a Master File accompanied with related data of the multinational group. In addition, an Israeli tax payor who serves as the ultimate parent of a multinational group which consolidated turnover exceeds 3.4 billion new Israeli shekels (sum may be subject to amendments) will be bound to submit a country-by-country report (CbCR) as well.

Record Keeping

4 to 7 years from the end of the tax year for which a tax return is filed.

Language for Documentation

Documentation may be prepared in English or Hebrew.

Small and Medium Sized Enterprises (SMEs)

There are no special provisions for SMEs, however, there is a safe-harbor rule that applies to "one-time transactions". A "one-time transaction" is not subject to transfer pricing documentation requirements if it abides by the (limited) instructions of the Israeli TP Regulations.

Deadline to Prepare Documentation

The deadline to prepare transfer pricing documentation is May 31 of the following year after the tax year and/or the date in which the financial reports are to be filed.

Deadline to Submit Documentation

Upon request by a tax AO, at the dates described above.

Transfer Pricing Methods

All OECD's transfer pricing methods are accepted, with a preference for the application of the CUP in the first instance. Where insufficient information exists to apply the CUP (internal or external), then one of the remaining methods (RPM, Cost Plus, Profit Split and TNMM) may be used, as long as it provides the most reliable results and the reason for its selection is provided. Other methods may also be used if the generally accepted transfer pricing methods are not applicable; however, this should be justified both economically and legally, and the application of a different method cannot normally be justified when one of the above-prescribed methods is applicable.

Recent Developments – Profit Split

The Israeli TP Regulations do not contain specific guidance for the application of the profit split method. Nevertheless, this method is acceptable to tax administrators in cases where both entities contribute or own significant intangibles, and has recently been advocated by certain officials of the ITA as a replacement for the TNMM, when discussing the results of Israeli (R&D, however not only) subsidiaries of foreign companies. The profit split method is most often applied in the context of global value chains, where the global operations of a multinational corporation are significantly integrated. Since the application of the profit split method also affects the earlier years of operation of the Israeli subsidiary, it has not been often applied yet by the ITA, however the ITA does challenge cost-plus (TNMM) models when they are not justified.

Comparables

Local comparables are preferred but are not often available. With evidence that a search for local comparables yielded no results , the use of European and/or US comparables may be accepted, as well as global benchmarks, so long as applicable adjustments were made (when required). However, this is examined on a case by case basis.

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