XVI. Transfer Pricing

A. *Scope of Provision*

Until the tax reform of 2003, the Income Tax Ordinance did not contain specific provisions relating to transfer pricing between related parties. Within the framework of the 2003 tax reform, section 85A was added to the Ordinance and provides that in an international transaction between parties enjoying a special relationship, where the prices or terms of the transaction are different from those that would have been established absent the special relationship, the transaction must be reported in accordance with prevailing ordinary market conditions.

A "special relationship" is defined as a relationship between related parties as well as a relationship resulting from the control of one party over the other party or the control of a third person over the parties to the transaction. A party to such a transaction may request a pre-ruling from the tax authorities with respect to a specific transaction or a series of similar transactions. The tax authorities are required to respond to the request within 180 days, and if the tax authorities fail to do so, the prices set forth in the request are regarded as the market prices.

Moreover, section 85A(e) of the Income Tax Ordinance empowers the Minister of Finance to prescribe methods for allocating income, expenses, deductions and credits in cases where transfer prices stray from market prices, as well as provisions relating to returns and documents to be filed with the Assessing Officer. In November 2006, the Minister of Finance prescribed rules under section 85A(e) — The Transfer Pricing (Determining Market Price) Regulations. The regulations provide that, to ascertain whether an international transaction was conducted between related parties at fair market prices, market research must be undertaken to compare the international transaction to similar transactions in accordance with specific comparison methods. Once a comparison method has been selected and the market research performed, the international transaction will be considered conducted at the fair market price, insofar as it does not deviate from the specified range of the market price. If the international transaction does deviate from the specified range, as determined by the regulations, the reported price of the transaction will be adjusted for tax purposes in the manner stipulated therein and the taxpayer will accordingly be subject to additional tax.

The Director General of the Israel Tax Authority (ITA) may order that the regulations will not apply to an international transaction if: (i) the transaction is a one-time transaction, or the scope of the transaction is small; and (ii) the concern that prices may be determined that depart from market prices in the above circumstances does not justify the application of the regulations. This type of transaction will be reported as if there is no special relationship between the parties.

With the approval of the Finance Committee of the Knesset, the Minister of Finance may prescribe with respect to all taxpayers or categories of taxpayers provisions regarding registration and documentation, and provisions regarding reports, documents and data that are submitted to the assessing officer, which will apply to taxpayers belonging to a multinational group.[929] A multinational group consists of two or more entities where both the following conditions are fulfilled: (i) at least one entity is a foreign resident; and (ii) one holds the control of the other entity(ies) (i.e., holds directly or indirectly 50% or more of one of the means of control).[930]

Section 4 of the Income Tax Ordinance provides that, where a person carries on in Israel an agricultural, manufacturing or other productive undertaking and sells any product of the undertaking in a wholesale market outside Israel or for delivery outside Israel, the full profits arising from the sale should be deemed to be income of that person accruing in or derived from Israel. These provisions do not apply if it is "shown to the satisfaction of the assessing officer that the profit has been increased through treatment of the product outside Israel other than by way of handling, grading, blending, sorting, packing or disposal," whereon "such increase of profit shall not be deemed income accruing in, or derived from Israel." If the taxpayer otherwise disposes, uses, or deals with any product of the undertaking outside Israel, the profits that might have been obtained if the taxpayer had sold the product in the most advantageous way in a wholesale market outside Israel are deemed to be the profits arising from its disposal, dealing, or use and to be income of the taxpayer accruing in or derived from Israel.

The Income Tax Ordinance does not contain a transfer pricing provision with regard to domestic transactions, but it is important to be aware of four provisions of the Ordinance in this context:

(i) Section 30 of the Ordinance provides that the amount of any deduction usually allowed in computing taxable income with respect to any expenditure must not exceed the amount required by the assessee to produce the income. Moreover, it provides that any question arising with respect to the denial of such a deduction must be decided by the Commissioner and is subject to appeal as if it was an assessment.

(ii) The assessing officer is empowered to allocate expenses incurred in the production of exempt income or partially exempt income in accordance with section 18(c) of the Ordinance. This section provides that, where the income of any person includes income for which a special rate of tax has been fixed or that is exempt from tax (known as "preferred income"), the expenses incurred by that person in producing the preferred income may be allowed as a deduction under section 17 only against that income. Where these expenses cannot be ascertained, there may be deducted from the preferred income such part of the expenses incurred by the taxpayer in producing his/her total income as bears to the total of such expenses the same ratio as the preferred income bears to the total income. Section 18(c) applies only to income from one of the sources enumerated by the Ordinance and does not apply to capital gains.[931]

(iii) Section 85(a) of the Ordinance indirectly accomplishes an allocation of expenses by taxing a transfer of trading stock at less than its market value. Trading stock that

[929] Income Tax Ordinance, s. 85B.

[930] Income Tax Ordinance, s. 85A.

[931] I.T.A. 11/82 *Leumi-Pia Ltd. v. The Assessing Officer*, 13 P.D.A. 130; C.A. 638/85 *Assessing Officer of Large Enterprises v. Malon Plaza Ltd.*, 18 P.D.A. 401.

ISBN 978-1-63359-061-8

belonged to a discontinued business or trading stock removed or transferred from the business other than for consideration or other than for full consideration is regarded as having been sold at its fair market value.[932]

(iv) Under section 86 of the Ordinance, the Assessing Officer may disregard a transaction, act or disposition that reduces or is liable to reduce the amount of tax payable if he or she believes that the transaction, etc., is artificial or fictitious, or that a particular disposition was not in fact carried out or that one of the main goals of the transaction, etc. is improper avoidance or improper reduction of tax. Section 86 of the Ordinance is a broad provision with flexible boundaries on which the Director General of the ITA may probably base an allocation of income. It reads as follows:

> *Where the assessing officer is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, or that one of the principal objects of a particular transaction is improper avoidance or improper reduction of tax, the assessing officer may disregard any such transaction or disposition and the person concerned shall be assessable accordingly. Avoidance or reduction of tax may be regarded as improper even if it is not contrary to law. For the present purpose, "transaction" includes an act. It has been held that, in order not to fall under section 86, a transaction must have a commercial basis apart from the desire to avoid or mitigate tax.*[933]

The Israeli District Court has clarified a ruling on artificial transactions in *Spector v. Large Enterprises Assessing Officer*.[934] The court stated that tax planning is subject to a two-step test. The first test examines whether the tax planning was "positive." Tax planning is positive when the taxpayer acts in accordance with the intended policy of the legislator concerning the granting of a tax exemption or tax relief. The second test examines whether the transaction concerned is artificial. An artificial transaction is a transaction that lacks fundamental commercial rationale. The objective burden proof (i.e., to prove that a transaction is artificial) lies with the ITA; the subjective burden proof (i.e., to prove that a transaction is based on a fundamental commercial reason) lies with the taxpayer.

These provisions are designed primarily to mitigate the consequences of tax avoidance and to allow for a true reflection of income. There is no requirement that the tax avoidance motivation be proven for the sections referred to above to apply. The provisions do not refer specifically to related companies, nor do they differentiate between foreign and Israeli taxpayers.

There are no provisions in the Ordinance to prevent double taxation as a result of the allocation of income or expenses. Hence, the allocation of income or expenses may result in double taxation in an international context. The special provisions enacted in the tax treaties to which Israel is a party, discussed in XVIII.B., below, offer some refuge to taxpayers.

Section 111 of the Income Tax Ordinance provides as follows:

> Where a nonresident person carries on business with a resident person, and it appears to the assessing officer that owing to the close connection between the resident person and the nonresident person and to the substantial control exercised by the nonresident person over the resident person, the course of business between those persons can be so arranged, and is so arranged, that the business done by the resident person in pursuance of the connection with the nonresident person produces to the resident person either no profits or less than the ordinary profits which might be expected to arise from that business, the nonresident person shall be assessable and chargeable to tax in the name of the resident person.

Section 114 of the Income Tax Ordinance provides that an attorney, factor, agent, receiver, branch or manager in whose name a nonresident person is chargeable to tax on profits arising from the sale of products manufactured or produced by the nonresident outside Israel, may apply to the assessing officer to have the assessment to tax on those profits made or amended based on the profits that might reasonably be expected to have been earned by a merchant. Where the goods are retailed by or on behalf of the manufacturer or producer directly, and proof to the satisfaction of the assessing officer of the amount of the profits is provided, the assessment may be made or amended accordingly.

B. Determination of Arm's Length Price

The determination of arm's length prices for inter-company transactions in Israel follows the Organization for Economic CO-operation and Development (OECD) Transfer Pricing Guidelines.

Section 2 of the Income Tax Regulations (Determination of Market Conditions), 2006, provides for the following transfer pricing methods:

(i) Comparable Uncontrolled Price Method (CUP) — The CUP compares the price of the controlled transaction to the price of an uncontrolled transaction that has similar characteristics and risks;

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[932] C.A. 59/87 *Hashkaot VeTamlugim Ltd. v. Assessing Officer Tel-Aviv 1*, Missim D-1 (Feb. 1990), E-22; I.T.A. 157/89 *Ramdo Ltd. v. Assessing Officer Haifa*, Missim E-2 (Apr. 1991), E-71; I.T.A. 2/91 *Kol v. Assessing Officer Jerusalem*, Missim G-6 (Dec. 1993), E-23; I.T.A 5025/96 *Plazenshtein Uri v. Assessing Officer Haifa*, Missim N-1 (Feb. 2000), E-124.

[933] C.A. 83/81 *T.M.B. v. The Assessing Officer*, 13 P.D.A. 253; C.A. 495/88 *Greenberg Ltd. v. The Assessing Officer*, 20 P.D.A. 171; C.A. 672/88, 2546/90 *Rami Lev v. Assessing Officer Haifa*, Missim G-1 (Feb. 1993), E-61; C.A. 823/75 *Hertsikowich v. The Assessing Officer for Large Enterprises*, 8 P.D.A. 299; C.A. 761/77 *Av-Na'al Ltd. v. The Assessing Officer for Large Enterprises*, 32 P.D. 494; C.A. 252/87 *Gachelet Hevra LeHashkaot Ltd. v. The Customs and V.A.T. Director*, 45(1) P.D. 245; I.T.A. 126/91 *Poplin v. Assessing Officer Haifa*, Missim I-1 (Feb. 1995), E-80; I.T.A. 110/95 *Gez v. Assessing Officer Hadera*, Missim K-1 (Feb. 1997), E-23; I.T.A. 1125/00 *Silban v. Assessing Officer Tel-Aviv 4*, Missim Q-4 (Aug. 2003), E-12; C.A. 3415/97 *Assessing Officer for Large Enterprises v. Rubinstein*, Missim Q-4 (Aug. 2003), E-3. The burden of proof lies, however, with the Assessing Officer, who has to persuade the Court that the transaction under consideration should be disregarded: C.A. 614/82 *Land Appreciation Tax Officer v. S. A. P. Ltd.*, Missim A-1 (Sept. 1987), E-24; P.C.A. 8522/96 *Rochvarger v. Assessing Officer Tel-Aviv 1*, Missim K-3 (June 1997), E-70; I.T.A. 1231/01, *Dobrovsky v. Assessing Officer for Large Enterprises*, Missim R-4 (Aug. 2004), E-14.

[934] Tax Appeal 5366-05-20 *Spector v. Large Enterprises Assessing Officer* (December 7, 2022).

ISBN 978-1-63359-061-8

(ii) Resale Price Method (RPM) — The RPM examines the gross margin earned by a reseller in a controlled transaction and deducts an appropriate resale margin from the resale price of the product;

(iii) Cost Plus Method (CPM) — The CPM is used when there is no market price available to serve as a basis for pricing. The CPM sets a price by calculating the standard cost of delivering the relevant goods and adding a standard profit margin;

(iv) Transactional Net Margin Method (TNMM) — The TNMM compares the net profit margin of a controlled transaction to the net profit margin of an uncontrolled transaction that is engaged in a similar transaction;

(v) Profit Split Method (PSM) — The PSM combines the profitability or potential profitability of the related parties in the transaction and split the profits in a way that is fair to both parties.

In *Broadcm Semiconductor Ltd. v. Assessing Officer Kfar Sava*,[935] the court upheld the arm's length principal and emphasized the importance of conducting a detailed functional analysis and a comparability analysis to determine the arm's length prices for inter-company transactions, and held that the inter-company agreements should be respected. *Medingo Ltd. v. Assessing Officer Afula*[936] is another significant transfer pricing case. This case involved a dispute over the transfer pricing of intangible assets. The court emphasized the importance of the preparation and signing of transfer pricing documentation, in order to reflect the transactions and the responsibilities, rights and obligations of the parties involved accurately. The case also highlighted the arm's length principle, and whether a transaction complies with the principle should be examined in two stages. At the first stage, the nature of the transaction should be examined. At the second stage, the price of the transaction should be examined, whether it is consistent with market conditions.

C. Reporting and Documentation

In July 2017, the OECD updated the guidelines on transfer pricing, aligning the recommendations from Action Plan 13 of the BEPS.

The Israeli transfer pricing documentation requirements usually includes the following components:[937]

(i) A Master File, which provides an overview of the global operations, organizational structure, and transfer pricing policies regarding the multinational enterprise group;

(ii) A Local File, which provides specific information about the company's transactions, including the nature of the transactions, the transfer pricing method applied, and the analysis supporting the arm's length pricing;

(iii) A Country-by-Country report, which is submitted in Israel by the ultimate parent entity resident in Israel, and provides detailed information on all entities within the multinational group; and

(iv) Other transfer pricing documentation, including a market conditions study.[938]

According to section 85A of the Income Tax Ordinance, the annual tax return requires a statement on whether international transactions were conducted. If so, ITA Form 1585 (see Worksheet 5) must be filed together with the annual tax return, and the filing must describe the international transaction at issue.

The market conditions study should be submitted to the assessing officer at the assessing officer's request within 30 days.[939]

Taxpayers are required to submit a Master File only if the multinational entities have a group revenue of the previous year of over NIS 150 million.[940]

Israel's Country-by-Country reporting requirements are consistent with BEPS Action 13 and apply to multinational enterprise (MNE) groups with consolidated revenue that exceeds NIS 3.4 billion and whose ultimate parent entity is a resident of Israel. The ultimate parent entity must electronically submit an annual country-by-country report to the ITA. The report will consist of financial and business data for each tax jurisdiction where the MNE operates, including details of the business activities undertaken by each group entity, along with their revenue, profit before income tax, and income tax paid and accrued. The report will be transmitted as part of automatic information exchange to other countries where there are entities of the multinational enterprise that are parties to an agreement signed by Israel.

An ultimate Israeli parent entity within a MNE group that is obligated to report to the ITA may choose to report in another country where a group entity exists, provided that a report regarding the choice is submitted to the ITA by the end of the applicable tax year.

Additionally, Israeli entities that are part of a MNE group that are not the ultimate parent entity, are also required to report to the ITA, indicating the country where the MNE group submits its reports. This report is included in the annual report that is submitted to the ITA, in addition to reporting through email.

In August 2023, the Israel-US Competent Authority Arrangement (CAA) on the exchange of Country-by-Country (CbC) reports was signed with a view to increasing international tax transparency. The CAA will improve access to information regarding the global distribution of income, taxes paid and indicators of the location of economic activity across the tax jurisdictions in which MNE groups operate. The US and Israeli Competent Authorities will exchange the CbC reports they receive from each Reporting Entity that is a tax resident in their respective jurisdiction annually, provided one or more Consti-

[935] T.A. (Merkaz) 26342-01-16 *Broadcm Semiconductor Ltd. v. Assessing Officer Kfar Sava* (2019).

[936] T.A. (Tel Aviv-Jafa) 53528-01-16 *Medingo Ltd. v. Assessing Officer Afula* (2022).

[937] Income Tax Ordinance, s. 85A(c), Income Tax Regulations (Determination of Market Conditions), 2006, s. 5.

[938] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(b).

[939] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(a).

[940] Income Tax Regulations (Determination of Market Conditions), 2006, s. 5(a)(10).

ISBN 978-1-63359-061-8

tute Entities of the Reporting Entity's MNE group is/are tax resident in the other Competent Authority's jurisdiction or is/are subject to tax on profits from business conducted through a PE located in that jurisdiction.[941]

D. Advanced Pricing Agreements

Advanced Pricing Agreements (APAs) are used to provide clarity regarding transfer pricing agreements. By entering an APA, taxpayers can engage with the tax authorities in order to agree on an accepted transfer pricing method. APAs aim to reduce the risk of transfer pricing disputes and provide a cooperative framework for resolving potential disagreements.

There are three types of APAs available in Israel:

(i) Unilateral APAs involve discussions and agreements between the taxpayer and the ITA. The APA is only valid for the tax year and the taxpayer discussed in the agreement;

(ii) Bilateral APAs are based on a single mutual agreement between the competent authorities of two tax administrations under the relevant tax treaty;

(iii) Multilateral APAs refers to a situation where there is more than one bilateral mutual agreement.

In order to file for an APA in Israel, taxpayers can engage with the ITA before formally submitting an application for an APA. The pre-filing consultation can help identify the potential issues. Once the taxpayer wants to formally apply for an APA, the taxpayer must submit an application to the ITA, providing detailed information on the intercompany transaction, transfer pricing methos, economic analysis, and any other relevant information. After the taxpayer submits the application, the ITA reviews the application and engages in negotiations with the taxpayer. Once an agreement has been reached, the APA if formalized in a written agreement.

E. Competent Authority

The competent authority that is responsible for handling transfer pricing matters in Israel is the Israeli Tax Authority (ITA). The ITA transfer pricing unit oversees transfer pricing issues and works to ensure compliance with Israeli transfer pricing rules and regulations. The transfer pricing unit is responsible for reviewing the different documentation and for providing taxpayers with the guidance they may need to address transfer pricing issues.

When there are cross-border transfer pricing issues involving an Israeli tax treaty, as the competent authority, the transfer pricing unit may engage in negotiations with the other tax authority.

[941] For more details see https://www.irs.gov/pub/irs-lbi/israel-exchange-arrangement-of-country-by-country-reports.pdf.

ISBN 978-1-63359-061-8