

## Income Tax Regulations (Determination of Market Conditions), 5767-2006.

By virtue of my authority under Paragraphs 85a(e) and 243 of the Income Tax Ordinance<sup>1</sup> (hereinafter – the Ordinance), and with the approval of the Knesset Finance Committee, I instate these regulations:

### Definitions

1. In these regulations –

**“Value range”** – The range of values between the lowest value and the highest value, as obtained from comparison of similar transactions;

**“Inter-quarterly range”** – The values located between the 25<sup>th</sup> centile and the 75<sup>th</sup> centile in the value range;

**“Comparability criteria”** – any one of these –

- (1) Area of activity, including manufacturing, marketing, sales, distribution, research and development, advice and provision of services;
- (2) The type of asset or service;
- (3) International transaction terms;
- (4) Risks, including geographical risks, financial risks and credit risks;
- (5) The economic environment;
- (6) The effect of the existence of goodwill or of other intangible asset;

**“International transaction”** – a transaction that is the subject of the examination and in which all these exist:

- (1) The transaction was made between parties all or some of which have special relationships between them;
- (2) One or more of the parties to the transaction is a non-resident, or the income from the transaction, in whole or in part, is income that is taxable outside of Israel as well;

**“Similar transaction”** – Any one of these, providing that, if no identical comparability criteria existed, adjustments were made in a manner whereby the impact of the difference between the comparability criteria of the results is canceled out:

- (1) A transaction between the tested party and a party that does not have special relationships with that party, in which the comparability criteria are identical, in their entirety or most of them, to the comparability criteria in an international transaction;
- (2) If there was no transaction as said in sub-paragraph (1) – a transaction between parties among which special relationships do not exist, in which the comparability criteria are identical or similar, all or most of them, to the comparability criteria in a transaction made by the tested party;

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<sup>1</sup> Laws of the State of Israel, New Version 6, page 120.

**“Similar party”** – A person whose comparability criteria are identical or similar to those of the tested party;

**“Tested party”** – A party to an international transaction in respect of which the following two exist:

- (1) It can be assumed that a comparison of similar transactions which he conducted will produce the most reliable results for the purpose of determining the market price;
- (2) Information exists on the party that is more suitable, proper and reliable than that on any other party;

**“Profitability margin”** – The profit or loss margin, as applicable, which will be determined in accordance with one of these methods:

- (1) In an area of activity in which a method is accepted determining a transaction price as a profit at a fixed rate that is added to the direct costs is– the profit at the fixed rate that was obtained in similar transactions;
- (2) In an area of activity in which a method is accepted determining a transaction price as a gross profit at a fixed rate of the sales of the purchasing party that is the tested party or a party similar to it the gross profit margin that was obtained in similar transactions;
- (3) Should it not be possible to determine the profit margin as said in sub-paragraphs (1) or (2) – the profit margin according to one of the following profitability indexes, which is most suitable for activity in the international transaction:
  - (a) The operating profit margin or operating loss margin according to profit and loss statements obtained in similar transactions;
  - (b) The ratio between the profit or loss, as applicable, and assets, liabilities and capital, in whole or in part, as applicable;
  - (c) Another profitability index that is the most suitable in the circumstances.

### **Determination of market conditions**

2. (a) For the purpose of determining whether an international transaction that has been conducted is a transaction in market conditions, a market conditions study will be conducted in which an international transaction will be compared with similar transactions by the tested party, in accordance with one of the methods detailed below:
  - (1) A method that compares between the price determined in the international transaction and the price determined in a similar transaction (in these regulations – the compared price method);
  - (2) Should it not be possible to use the price comparison method – in accordance with one of the following comparison methods that is the most suitable in the circumstances:
    - (a) A method that compares the profitability margin between the international transaction and the similar transaction;
    - (b) A method that compares the international transaction with the similar transaction, in accordance with the accepted distribution of profit and loss

between parties in joint activity, taking into account the contribution of each party to the transaction, including the party's exposure to risks and rights to the assets connected with the transaction;

(3) Should it not be possible to use a price comparison method or one of the methods detailed in sub-paragraph (2) – another method that is the most suitable in the circumstances, which compares the international transaction with a similar transaction.

(b) An international transaction will be regarded as a transaction at market conditions if as a result of its comparison in accordance with the comparison methods for similar transactions, the result obtained does not exceed the inter-quarterly range obtained in the comparison with similar transactions. Should however the comparison method be the price comparison method and adjustments were not made for canceling out the effect of the difference on the comparability criteria, the transaction will be regarded as transaction at market conditions if the price does not exceed the value range in similar transactions.

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(c) Should it not be possible to regard an international transaction as a transaction at market conditions as said in sub-regulation (b), the transaction price will be reported according to the value located in the 50<sup>th</sup> centile in the value range.

### **Special rules concerning comparison with similar transactions**

3. These rules will apply to comparison with similar transactions:

(1) Similar transactions that were conducted no more than three tax years prior to the execution of the transaction examined will be selected;

(2) All the similar transactions which the similar party conducted in the three tax years prior to the year in which the international transaction was executed will be regarded as a single transaction, unless it is proved to the satisfaction of the assessment officer that in the course of those years, in their entirety or in part, or in the previous years or in the subsequent years, a material change occurred in the comparability criteria as a result of which only part of the similar transactions are to be regarded as a single similar transaction;

(3) The price, profitability margin, profit distribution as said in regulation 2(a)(2)(b), or other method as said in regulation 2(a)(3), as applicable, in similar transactions that are regarded as a single similar transaction as said in sub-paragraph (2), will be the average price, average profitability margin, average profit distribution or average results obtained in accordance with another method as said, as applicable, in all the similar transactions that are regarded as a single similar transaction;

(4) The comparison between an international transaction and similar transactions will be made in accordance with the same method.

### **A one-time transaction**

4. Regulations 2 and 3 will not apply to a one-time international transaction that has been approved by the assessing officer as a one-time international transaction as said, and the transaction will be reported as if the price or terms, as applicable, had been determined between parties among which special relationships do not exist.

### **Reporting on a market conditions study**

5. (a) An assessed person who is party to an international transaction, to which transaction regulation 4 does not apply, will submit to the assessing officer at the assessing officer's request, within 60 days, a report in which he will detail the following data:

(1) The assessed person's details, including owners of rights controlling the assessed person, directly or indirectly, every body of persons in which he holds directly or indirectly, every body of persons and details of the recipients or beneficiaries of the rights as said;

For the purposes of this sub-paragraph, the term "control" and "holding" – as "control" is defined in Paragraph 85a of the Ordinance;

- (2) The parties to an international transaction, their residence and statement of the assessed person's special relationships with them;
- (3) The contractual terms of an international transaction including details of the assets, the service provided, the price that was given, the terms of the loan and credit and guarantees;
- (4) The assessed person's area of activity and developments in it;
- (5) The economic environment in which the assessed person operates and the risks to which he is exposed;
- (6) Use of intangible assets, directly or indirectly;
- (7) Details of all the transactions made by the assessed person with a party to the transaction, including loans, payment of management fees, partnerships, joint ventures, gifts, guarantees, trust agreements and any other agreement;
- (8) 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.
- (9) The manner of reporting on the transaction in the foreign country, including as part of a request for a preliminary decision, if submitted, and reporting on the transaction's data in the foreign country and whether there was a difference in the reporting in the foreign country and the reporting in Israel – explanations for the existence of the said difference.

(b) To be enclosed with the said report in sub-regulation (a) are the transaction contracts, the other contracts between the parties with which special relationships exist, other documents for the verification of the data submitted, a market conditions study and an analysis of transfer prices and market conditions that were conducted in accordance with these regulations, a market conditions study or an assessment that was conducted in order to be submitted to a foreign tax authority, the report that was submitted in a foreign country and every determination by the tax authority and a statement of opinion of a CPA or lawyer, if given.

- (c) With respect to an assessed person who is party to an international transaction to which regulation 4 applies, the directives of sub-regulations (a)(1) to (7), (a)(9) and (b) will apply, except that with regard to the market conditions study and transfer price analysis as said in sub-regulation (b), in which the obligation to enclose them will apply only if they have been conducted.
- (d) In the report in accordance with Paragraph 131 of the Ordinance, the assessed person will report on the execution of an international transaction and its prices and terms and its price and its terms under the market conditions in accordance with a form determined by the director.

**Transition rule**

- 6. These regulations will apply to an international transaction that was executed on and after the date of their publication. However, a market conditions study that was conducted before the publication of these regulations will be regarded as a market conditions study that was conducted in accordance with these regulations, this for two years from the date of their publication, providing that it was conducted in accordance with the accepted guidelines published by the OECD or its member countries.

Avraham Hirschson  
Minister of Finance

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\_\_\_\_\_ (2006)  
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