חטיבת שומה וביקורת - מחלקת מחירי העברה

July 24, 2011

Re: Stock Option Compensation regarding Transfer Pricing

1. Preface

Many Israeli companies act as service providers to their foreign related parties. These services include, among other, research and development (R&D), marketing, logistic, management (from here and after **"The Services"**). In most of the inter-company agreement between the parties, the compensation mechanism due these services is based on the costs involved in the provision of the service with an additional fix markup (**"The Compensation"**).

A service transaction between related parties falls within the definition of section 85a of the Income Tax Act and the Israeli Tax Authority's Income Tax Regulations (Determination of Market Terms) – 2006 (**"The Regulations"**). The regulations determine that the arm's length of the compensation is determined according to the Comparable Profit Method, where the profit level indicator is the markup on costs (**"Cost Plus"**).

The service provider companies' costs include among other payroll and wages expenses as well as payments to sub-contractors. Sometimes the payments due these expenses are provided through payroll substitute such as shares and stock options.

The Israeli accounting standard #24 (based on IFRS #2) which came into forces in 2006 covers the accounting treatment of stock based compensation. This standard determines the required disclosures, to enable the financial books users to understand among other the effect of the stock based compensation payments on the profit or loss of the entity in the period and on its financial results. In other words, the standard determines that one has to value the benefit that was granted to the employees and to record it as an expense in its profit and loss statement.

The expenses due stock based compensations may sourced either from allocation of options of the direct employee (the Israeli company) or from the related company (a foreign company).

2. The transfer pricing division's approach to payments based on stock based compensation

The transfer pricing division (TPD) faced many cases where the question of the arms' length regarding services provided to a related party and whether stock based compensation payments, are to be included in the pool of the 'cost plus'.

I would like to bring to your attention that currently this issue was brought as a case to court. This case is also under a Mutual Agreement Procedures.

In this case the TPD approach was that the stock based compensation payments (as calculated according to the Israeli GAAP) need to be included as part of the total expenses, for calculating the total compensation in providing the service. In other words, the stock options expenses that were recorded need to be included in calculating the Cost Plus.

3. Clarifications to the field tax offices directors

In order to maintain a unified treatment in the files that include this subject, it is required to address the TPD, for consultation, The TPD will review the transfer pricing report ("the report"), based on the Section 85A and the regulations, and when applicable, shall adjust the comparable companies in the report in order to achieve a higher level of reliability of the comparison,

Regards,

Dr. Haim Gabbay
Senior Vice President Assessment & Audit
Israel Tax Authority