CORPORATE TAX - ISRAEL

Business models for marketing and sales operation – tax implications

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Introduction

This article provides a high-level overview of some of the common business models used by local entities that are engaged in the distribution, sale and marketing of their group's products and analyses the potential transfer pricing ramifications thereof.

The transfer pricing analysis included in this article is predominantly based on Circular 11/2018 (Determination of the appropriate transfer pricing method for activity related to distribution, marketing and sales of a multinational group within the local market),(1) published by the Israeli Tax Authority (ITA). Circular 11/2018 implements the Organisation for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (OECD guidelines).

Transfer pricing – general

Transfer pricing rules deal with pricing and profit attribution rules of international transactions performed between two or more related parties (eg, a parent and its subsidiary) ('controlled transactions').

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 an inappropriate price or inappropriate terms may be determined for the transaction for the purpose of maximising benefits, such as erosion of the tax base (eg, by determining a price or expense that is higher than the market price for a profitable company that buys or receives a service from a losing company).

Section 85A of the Income Tax Ordinance (New Version), 5721–1961, and the regulations thereunder set out the transfer pricing rules which apply in Israel and provide that in determining the pricing of a controlled transaction, an 'arm's-length standard' (ie, market condition) should apply.

The arm's-length price and profitability of an entity participating in such a controlled transaction typically relate to the functions, risks and intangible assets associated with its activities. Therefore, it is important to define the business model selected, as this will drive the type and amount of compensation that can be determined under arm's-length principles and will define which country will enjoy the largest portion of the profits.

Common business models for sales and marketing operation

In every business activity, the sales function, including the presale process, is a material and important component. The selling function includes:

- means for selling the merchandise or service;
- means for creating and retaining customer relations; and
- efforts and strategies for attracting new customers.

The presale function includes:

- market penetration;
- contacting regulators;
- initiating selling activity; and

- identifying relevant customers.

Insofar as the local representative constitutes an integral part of the selling process, the pricing of that representative will be derived from its objective – the sales themselves. If its activity is not an integral part of the selling process, its pricing will be derived from a different indicator (eg, related costs).

For transfer pricing purposes, the extent of integrality is generally determined based on the functions, assets and risks associated with an entity's activities (FAR analysis).

A FAR analysis generally starts with an analysis of the contract between the parties as well as an examination of the legal ownership of the multinational enterprise's (MNE's) assets (with special emphasis on intangible assets), but does not end with this. It should be examined whether, substantially, the actual conduct of the parties agrees with that stated in the contracts or registration.

In this respect, it will not be enough to identify who signs the transaction. It will have to be examined:

- who actually carried out the selling activity;
- who determined the terms of the transaction; and
- who worked on soliciting and creating demand on the part of specific customers as a result of direct contacts with them and not as a result of widespread marketing activity directed at the general population.

According to the arm's-length principle, the rule of thumb is that insofar as the functions, assets and risks of the local representative are more limited, its share of the profit expected from the activity will be lower and vice versa.

Therefore, as mentioned above, it is important to define the business model selected, as this will drive the type and amount of compensation that can be determined under arm's-length principles and will define which country will enjoy the largest portion of the profits.

Some of the common business models used by MNEs for their sales and marketing operation are:

- full-fledged distributor (FFD);
- limited risk distributor (LRD);
- commission agent (CA); and
- marketer.

The key characteristics of these popular business models are outlined below.

FFDs
A traditional FFD undertakes all of the sales and distribution functions as well as the typical risk incurred in performing these functions (eg, inventory, credit and market risks).

The FFD buys, holds and sells products and, as with an LRD, local revenue is recorded on its books.

The FFD may also be responsible for certain strategic and operational marketing activities, such as the development of a market penetration strategy. As a result of its operation, the FFD will usually develop the associated marketing intangibles, such as customer relationships and trademarks or trade names.(2)

Some of the principal characteristics of an entity that is an FFD are as follows:

- It bears the principal responsibility in the transaction and not the manufacturer.
- It is responsible towards and with regard to the customer. This will usually include supply of the product, including representations made over the course of marketing and determining the selling terms which make it responsible.
- It bears the inventory risk – a risk that usually exists when inventory is ordered before being sold to the customer – or is responsible for product returns. It bears the risk of physical loss of inventory.
- It bears the customer credit risk.
- It has a reasonable range of action under economic restrictions to set the price of the transaction.
- It can determine the supplier of the product or service.
- It is involved in the product or service characterisation process at the customer.

In the case of an FFD, the pricing for transfer pricing purposes would generally be derived from the sales that the FFD creates and reflect the broad functions and risks that it assumes.

The comparable profits method (CPM)(3) is generally considered appropriate for an FFD operation model. The CPM method examines the net profit relative to an appropriate base (eg, costs, sales and assets) that a taxpayer realises from a controlled transaction,(4) whereas in the case of an FFD, the profit rate will usually be

determined as operating profit divided by sales and will be affected by the extent of the functions, assets and risks associated with the FFD's operation.

As an example, assume that USCo provides FFD services to its parent, IsrCo. Also assume that Company A, a US entity, and Company B, an Israeli entity, which are unrelated, have exactly the same business model. IsrCo and USCO may now look at Company A's books to determine a good arm's-length price. To that end, IsrCo and USCO would have to find Company A's ratio of earnings before interest and taxes (EBIT) to turnover.

Profit and loss – Company A

Sales revenue	$500,000
Cost of goods sold	$325,000
Selling and operating expenses	$100,000
Profit (EBIT)	**$75,000**
Net profit margin = EBIT ($75,000) / turnover ($500,000)	15%

The second step is to calculate the arm's-length transfer price. For this, USCo would simply charge a price at which the net profit margin is no less or more than 15%.(5)

According to Section 4.1 of the circular, the 'profit split method' may also be applied in cases where the FFD owns significant marketing intellectual property. Very generally, the profit split method seeks to split the combined profits of an MNE between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. In practice, allocation keys based on assets/capital (operating assets, fixed assets, intangible assets and capital employed) or costs (relative spending and/or investment in key areas such as research and development, engineering and marketing) are often used.(6)

LRDs
In general, an LRD is a buy-sell organisation that performs all sales and distribution functions and has a limited risk profile. The principal characteristic of a distribution company that is operating according to this LRD model is similar to a local entity that operates according to an FFD model but operates with lesser risks.

In addition, in many industries, an LRD has little or no strategic marketing responsibility (as opposed to an FFD). Therefore, it would usually avoid the associated risks, including some market risk, and typically does not develop the associated marketing intangibles.

In terms of passage of title to the goods, the ownership may be in the nature of a 'flash title', meaning that the LRD has ownership over the product for a limited period. Therefore, activities such as logistics and warehousing are stripped from the distributing entity. Also, the LRD may be required to pay for its purchases only after it has collected its own receivables from customers.(7)

The following are certain principal characteristics of an LRD that are similar to those of an FFD:

- selling activity to domestic customers, including presentation of products to potential customers, negotiation, designation of the sell transaction, product customisation and notification of customers of product developments (eg, updates);
- customer retention activity;
- a large number of customers relative to the local market;
- regularly updated on the situation of the inventory. This can be either by management of the inventory on the books, by means of joint systems or by receiving regular updates from an unrelated local company that provides distribution, storage or logistics services;
- work management with a local supplier of logistics services;
- employees involved in sales are among the highest paid employees of the entity carrying out the activity;
- the employees have expertise in the area of the sales activity;
- the local entity is a representative of the MNE on the local market; and
- ownership over the inventory may be transferred to the LRD, which may also bear the customer credit risk. Local revenue and costs of goods are recorded on the entity's books.

The following are certain principal characteristics of an LRD that are different from those of an FFD:

- The service agreement with the managing entity would usually call for the managing entity to compensate the LRD for various costs and would effectively transfer various risks and functions to the managing entity. As such, the LRD may formally undertake risks regarding collection and inventory but will be compensated for these by the managing entity if necessary. For example, the service agreement will include provisions

for compensation by the managing entity for bad debts and an option for the LRD to sell back (at cost) to the managing entity slow-moving or obsolete inventory.
- The distribution services do not require the utilisation of unique and significant intellectual property and do not result in the creation of such intellectual property.
- The marketing strategy and related expenses will be paid and decided by the managing entity.

The pricing for the LRD services for transfer pricing purposes should be derived from the sales that the LRD creates and reflect the broad functions and the lower risks that it assumes and the lack of significant marketing intellectual property. The lower risk should be reflected in the company's profitability rate.

The CPM method is generally considered appropriate for an LRD operation model, whereas the profit rate will usually be determined as operating profit divided by sales and will be affected by the extent of the functions, assets and risks associated with the LRD's operation.(8)

If the LRD does not own marketing intellectual property and does not assume business risks, an operation income equal to 3% to 4% out of the LRD's sales is within the safe harbour boundaries for Israeli income tax purposes.(9)

CAs

A CA(10) generally operates as a sales representative who does not purchase products for resale, but receives a commission on the sale of products to customers on behalf of the manufacturer or distributor.

The CA undertakes fewer operational functions than an FFD and LRD and is typically not involved in any strategic or marketing activities.

Functions performed by the CA include:

- identifying potential clients;
- introducing new products and taking customer orders; and
- maintaining customer relations (but providing only limited technical assistance).

The CA characteristics include the following:

- Terms and contracts are agreed to outside the local country with little input from the CA.
- The CA does not take title to goods and usually incurs no market risks or risks relating to either marketing or technology intangibles.
- Local revenue is usually not recorded on the books of the CA, only sales expenses. Thus, revenue is limited to the sales commission.

In such an arrangement, the principal, which is located outside the country of the CA, should be careful to avoid being characterised as having a permanent establishment in such jurisdiction and should be mindful of such jurisdiction's tax and reporting obligations (even in the absence of a physical presence).(11)

For a CA, the commission received is usually determined as a fixed profit rate that is added to the direct costs and usually constitutes a modest return, due to the fact that only a few functions are performed and little risk is incurred by the CA.

The CPM method is generally considered appropriate for a CA operation model, whereas the profit rate will usually be determined as operating profit divided by operating costs and will be affected by the extent of the functions, assets and risks associated with the CA's operation.(12)

As an example, USCo provides CA services to its parent, IsrCo. Company A, a US entity, and Company B, an Israeli entity, which are unrelated, have exactly the same business model. ISrCo and USCo may now look at Company A's books to determine a good arm's-length price. To that end, IsrCo and USCo would have to find Company A's ratio of EBIT to related costs.

Profit and loss – USCo

Sales revenue	$500,000
Labour costs	$225,000
Office expenses	$100,000
Selling and operating expenses	$75,000
Total costs	**$400,000**
Profit (EBIT)	$75,000

Net cost plus margin = EBIT ($100,000) / total costs ($400,000)	25%

The second step is to calculate the arm's-length transfer price. For this, USCo would simply have to add the net cost plus margin (in the example – 25%) to its existing total costs.(13)

Marketers

A marketing services entity set up in the customer jurisdiction is generally not directly engaged in the distribution of tangible products. Instead, it provides local sales support and marketing services for the MNE, such as advertising, market research and economic analyses relating to sales.

The marketer will only discuss contracts with customers and advise them to conclude contracts directly with the principal. Contracts are then concluded by the principal and the customer, typically via an online form or other means.(14)

The principal characteristics of a marketer are as follows:

- The customers do not consider the local representative to be responsible for any problems.
- There is a small number of customers on the local market.
- The local representative has a small number of employees.
- The employees of the local representative are not compensated on the basis of sales in the territory.
- The employees are not professional enough to help sales in this area in view of the product's complexity. Their job is only to create contacts between employees of the managing entity, who have the skills to execute the selling activity, and the customers.
- The salary of the salespersons of the marketer entity is low compared with the market in which it operates and thus demonstrates the lack of value of such salespersons to the selling process.
- The activity of the local entity is more characterised by advertising activity, performing market research and market segmentation, among other things.
- There is a different official distributor on the local market and the local representative sells only to the official distributor.

Under this model, the entity only carries out marketing activity. The profitability of the local marketer is usually determined as a fixed profit rate that is added to the direct costs and usually constitutes a modest return, due to the fact that only a few functions are performed and little risk is incurred by the marketer.

The CPM method is generally considered appropriate for a marketer operation model, whereas the profit rate will usually be determined as operating profit divided by operating costs and will be affected by the extent of the functions, assets and risks associated with the marketer operation.

If the marketer does not own marketing intellectual property and does not assume business risks, an operation income equal to 10% to 12% out of the marketer's operating costs (ie, operating costs + 10% to 12%) is within the safe harbour boundaries for Israeli income tax purposes.(15)

For further information on this topic please contact Anat Shavit or Yuval Peled at Fischer Behar Chen Well Orion & Co by telephone (+972 3 694 4111) or email (ashavit@fbclawyers.com or ypeled@fbclawyers.com). The Fischer Behar Chen Well Orion & Co website can be accessed at www.fbclawyers.com.

Endnotes

(1) For the English version of the circular, see also "Unofficial English translation from the original Hebrew ITA circular provided by KPMG in Israel".

(2) "Transfer Pricing Business Models (2017)", Angela Sadang and Jeanne P Goulet, available here.

(3) This method is also known (particularly in the European Union) as the 'transactional net margin method' or 'TNMM'.

(4) OECD guidelines, para 2.64.

(5) Further information on the transactional net margin method is available here.

(6) OECD guidelines, paras 2.114 and 2.141.

(7) *The Commissionaire Distributer Model in a Post-BEPS Environment* (2017), Wiljami Siitonen, pp 12-13.

(8) Circular 11/2018, Section 4.2.

(9) ITA Circular 12/2018, Section 3.3.

(10) Please note that this business model is not included or covered by Circular 11/2018.

(11) *South Dakota v Wayfair, Inc*, 585 US ___ (2018).

(12) Sadang & Goulet.

(13) Further information on the transactional net margin method is available here.

(14) Siitonen, p 13.

(15) Circular 12/2018, Section 3.3.

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