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Global Tax Alert

News from Transfer Pricing

Israel's Tax Authority releases tax circular on burden of proof related to transfer pricing audits

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Executive summary

The Israeli Tax Authority (ITA) published, on 2 June 2020, a tax circular that sets forth the situations in which a transfer pricing (TP) study that is filed by a taxpayer will be considered as meeting the Israeli TP standards in accordance with Section 85A of the Income Tax Ordinance (ITO) and its Regulations (the Circular). If the TP study is considered to meet the requisite standards, the burden of proof, as part of the audit procedure, will transfer from the taxpayer to the tax assessor to rebut the facts and analysis performed by the taxpayer. Accordingly, the appropriate documentation has a significant impact on the audit procedure and the parties' respective positions.

Detailed discussion

The Circular outlines the relevant rules and regulations regarding the taxpayer's obligation to file the relevant TP study within 60 days following the ITA's request and provides (based on cross-references to the [Kontera Case](#)) that the **mere filing** of documents as required by law is not sufficient to transfer the burden of proof to the tax assessor. Rather, the documents must meet the requirements set forth in the law to be considered as a Transfer Pricing Study for purposes of shifting the burden of proof and penalty protection.

According to the Circular, where the facts of the relevant case are disputed, the burden to prove those facts, that serve as the basis of the study, will be placed on the taxpayer. For example, it is possible that the tax assessor may recharacterize the transaction and claim that the study is irrelevant.

It is further provided that a TP study should include all documents required by the Regulations (not an exclusive list), as well as additional documents that support the facts and the application of the transfer pricing methodology.

Based on the Circular, the documents filed as part of the TP study should support the taxpayer's positions and lead to the conclusion of the study in a way that presents a connection between the facts and the analysis. Furthermore, the study should also include documents indicating the implementation of the market price determined in the books of the other parties to the transaction that are not the taxpayer.

If a taxpayer's TP study does not meet the requirements in the regulations, the burden of proof will not be transferred to the tax assessor. The Circular provides, as an example of deficient documentation the situation where the parties to the transaction own valuable intangibles that contribute significantly to the shared profit or loss and the taxpayer applies the cost-plus method, without a reasonable explanation of why the profit split method is not more reliable. In this situation a taxpayer will not meet the requirements of Section 85A. The Circular lists other examples.

According to the Circular, if the taxpayer did not file a TP study, or where the TP study that was filed does not meet the relevant requirements, the tax assessor will not be required to perform a comprehensive study, but may issue an adjustment based on "estimations, assessments, and personal experience." For this purpose, the documents filed by the taxpayer can be used by the tax assessor.

It is further clarified that if a TP study is not filed or if it is filed but does not meet the required threshold, the tax assessor may use all relevant sanctions under the law, including a deficit penalty according to Section 191 of the ITO, with the approval of the ITA's TP department.

Implications

Multinationals with Israeli activity should carefully review this Circular and consider whether their TP documentation aligns with the Israeli TP standards to ensure their documentation is sufficient to: (i) transfer the burden of proof to the tax assessor; (ii) be better positioned in a potential audit; and (iii) avoid penalties of non-compliance with the required standards. Transactions that are not well-documented in a way that will satisfy the Israeli TP requirements are at risk of putting the company in an inferior position in front of the ITA during a potential audit and may also result with significant penalties.

For additional information with respect to this Alert, please contact the following:

EY Israel, Tel Aviv

- ▶ Sharon Shulman sharon.shulman@il.ey.com
- ▶ Lior Harary-Nitzan lior.harary-nitzan@il.ey.com
- ▶ Eyal Gonen eyal.gonen@il.ey.com

Ernst & Young LLP (United States), Israel Tax Desk, New York

- ▶ Lital Haber lital.haber1@ey.com

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