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CLIENT UPDATE



New ITA Circular on the Burden of Proof in Transfer Pricing Matters

June 4, 2020

On June 2, 2020, the Israeli Tax Authority (the "ITA") published [Tax Circular 1/2020](#) (the "Circular") which clarifies the ITA's position with respect to bearing and meeting the burden of proof in transfer pricing matters upon audit and the power of a tax assessing officer to reject a transfer pricing study without presenting and relying on an economic analysis.

Background

Section 85A of the Israeli Income Tax Ordinance ("ITO") and the regulations promulgated thereunder (the "TP Regulations") generally require that all cross-border transactions carried out between related parties be consistent with the arm's-length principle. Section 85A(c)(1) further provides that, upon request by an ITA assessing officer, a taxpayer may be compelled to furnish documentation relating to related party transactions, including contemporaneous economic studies or analysis regarding transfer pricing models and percentiles ("TP Documentation").

Prior to the currently issued Circular, the ITA had issued Circular 3/2008 (the "2008 Circular"). In Section 2.5 of the 2008 Circular, the ITA clarified the burden of proof and methods of proof with respect to determining fair market values. The 2008 Circular provided that once the taxpayer delivers the TP Documentation required by the ITO and the TP Regulations, the transfer pricing agreed to between the parties is presumed correct. If an assessing officer makes a tax determination based on pricing that differs from such agreements, the assessing officer would bear the burden of proof for such determination.

The 2020 Circular

The Circular cancels and replaces Section 2.5 of the 2008 Circular, and focuses on the initial burden of proof that rests with the taxpayer and what such burden entails. The Circular

provides that mere delivery or submission of TP Documentation is not sufficient and that in each case a determination must be made whether such documentation meets the statutory requirements.

The Circular suggests that the burden borne by the taxpayer is a matter of all or nothing. The TP Documentation could be rendered irrelevant if the taxpayer fails to prove or is missing certain important elements, such as, but explicitly not limited to, the following:

- Evidence regarding the steps for identifying comparable companies;
- List of companies manually eliminated from the class of comparable companies;
- List of companies that were chosen to serve as comparable companies;
- Financial or accounting data of the comparable companies used for determining fair market pricing.

If the TP Documentation is found to be incomplete, the taxpayer would be treated as if it has failed to submit any TP Documentation and the burden of proof would not shift to the ITA. In such case, the assessing officers would not be required to prepare any alternate economic study but rather may make a tax determination according to their best judgement, and may rely on estimates and their personal experience, among other factors.

The Circular concludes with acknowledging the high standard that would be imposed on the ITA once the taxpayer has met its burden of providing all the relevant and appropriate TP Documentation. Quoting again from Kontera, in order for the ITA to make a determination that is different from the taxpayer's, the ITA would be required to furnish clear and convincing evidence which would presumably require economic analysis on par with the study submitted by the taxpayer.

Our Analysis

To some extent, the Circular is a self-serving expression of the ITA's position and practice that imposes an unreasonably high bar for the taxpayer to meet and, at the same time, fails to explicitly provide a parallel or even an objective standard or requirement of reasonableness for the ITA assessing officers.

First, it could be argued that the Circular deviates from the Supreme Court's holding in *Kontera Technologies Ltd. v. Assessing Officer Teal-Aviv 3* ("Kontera"). The Circular correctly quotes from the ruling the Court's statement that the initial burden of persuasion in cases involving transfer pricing (Section 85A) rests on the shoulders of the taxpayer. However, the subsequent sentence in the Kontera ruling states, "To the extent that this burden was met, i.e., [the taxpayer] furnished all the necessary documents as well as conducted market research pursuant to Section 85(c)(2) [sic], the burden of bringing the evidence – in the language of that section, the "evidentiary duty" – will be transferred to the assessing officer, who will be required to base his determination on the price of the transaction under the market conditions." (Emphasis added.)

While the Kontera opinion does state that the taxpayer's burden is to provide "all the necessary documents," this should not be insurmountable. The Circular's language, regarding an open-ended list of items that could render TP Documentation to be treated as incomplete, coupled with a statement regarding the assessing officer's right to make a determination according to his best judgement, leaves open a rather wide door for potential abuse. We believe that the Kontera holding should be interpreted in a reasonable manner and that in applying it, the assessing officer is still bound by all general principles of administrative law.

The position of the ITA in the Circular is not consistent with the general approach to transfer pricing audits in OECD countries. In the OECD Transfer Pricing Guidelines for Multinational

Enterprises and Tax Administrations, the OECD notes that in most countries the burden of proof is on the tax authority. In some of these jurisdictions, the tax authority may reasonably require the taxpayer to produce records that enable a transfer pricing examination, and in some jurisdictions, the tax authority may rely on estimates in situations where a taxpayer has acted in bad faith. In some countries where the burden is on the taxpayer, the burden may shift once the taxpayer has presented a reasonable argument. The OECD comments that differing national approaches to the burden of proof should not be misused by taxpayers or tax authorities, and as a matter of good practice, neither should rely on the burden of proof "as a justification for making groundless or unverifiable assertions about transfer pricing".

Furthermore, the position in the Circular establishes an asymmetry between the assessing officer and the taxpayer that could potentially violate the obligations under general principles of administrative law. Such principles generally provide a comprehensive duty for administrative agencies to state the reasons for their decisions. This obligation requires an agency to state the factual basis for a decision as well as the legal and policy grounds on which it is based. Therefore, despite the position presented in the Circular, an assessing officer is, nonetheless, required under the Law of Reasoning to conduct his own, independent economic analysis in support of any transfer pricing such assessing officer may determine.

Conclusion

The Circular expresses the ITA's position that, in the context of a transfer pricing audit, the standard for determining when and if a taxpayer has met its burden of proof may itself be subject to the discretion of the assessing officer. The TP Documentation submitted by a taxpayer may be considered incomplete if it is a missing any item from an open and unspecified list. Further, where such TP Documentation is determined to be incomplete, the ITA's position is that the ITA bears no burden of proof and the Circular purports to grant the ITA assessing officers broad discretion to apply their best judgement for making TP determinations.

While the Circular is instructive insofar as understanding the ITA's positions and practices and thus what is to be expected in the course of an audit, we note that the ITA's position does not have the force of law. If ITA assessing officers abuse the discretion granted under the Circular and impose tax determinations that are not reasoned and not supported by economic analysis, taxpayers should make note that such determinations could be considered arbitrary or capricious and could be overturned upon judicial review.

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