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CLIENT UPDATE



Proposed New Israeli Legislation on Transfer Pricing Documentation

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A proposal for new transfer pricing legislation published for public comments on October 12th, 2020 – The Israeli Tax Authority takes further steps to line up with OECD BEPS requirements

Overview. The Israel Tax Authority (the "ITA") has published proposed new legislation intended to significantly change the requirements of transfer pricing documentation and to subject multinational enterprises present in Israel to new and extensive reporting obligations. The new legislation seeks to make the ITA's requirements consistent with those of other OECD members which have already implemented similar mechanisms, but adds overreaching requirements that will not only affect all taxpayers but will also in many cases shift the burden of proof and discharge the ITA from having to support its claims with independent works of its own.

The OECD's stance on transfer pricing and the Israeli perspective. Action 13 of the OECD's Base Erosion and Profit Shifting (BEPS) report, published in 2015, introduced a standardized approach to transfer pricing documentation. It is a three-tiered approach, consisting of a local file, a master file and a Country-by-Country Report ("CbC Report"). The local file, similar to the current requirements of the Israeli transfer pricing law, refers to the intercompany transactions of a local taxpayer; the master file refers to standardized extensive information regarding all members of a multinational group usually filed by one Ultimate Parent Entity (as defined below); and the CbC Report, for multinational enterprises with revenue of at least EUR 750M (NIS 3 Bn) refers to information relating to global allocation of a multinational group's income, taxes and certain indicators for the location of economic activity within the group. Such CbC reports are to be exchanged between Israel and other countries that signed the Multilateral Company Authority Agreement (the "Multilateral CAA").

While over 90 countries already implement this standardized approach, Israel was lagging behind as evident in recent Inclusive Framework Third Phase Peer Review just published by the OECD. Section 85A of the Israeli Tax Ordinance (the "ITO") and the regulations thereunder referred only to a 'local file' as supplemented by ITA circulars 15/2018 on "Business Restructuring in Multinational Enterprises" ([click here for our alert](#)) and 1/2020 on "New ITA Circular on the Burden of Proof in Transfer Pricing Matters" ([click here for our alert](#)). Now, Israel will implement the Multilateral CAA in the Exchange of Country-by-Country Reports it signed in 2016.

New Terminology for Israeli Companies. The proposed legislation introduces new definitions.

- **Multinational Enterprise ("MNE")** - A group of at least two entities in which (i) at least one of the entities is foreign; and (ii) one entity controls the other entities directly or indirectly. Any Israeli entity which is a part of an MNE group will be obligated to update the ITA in the tax return.
- **Ultimate Parent Entity ("UPE")** – Generally, the entity at the top of the ownership chain of the MNE. May also be defined as the entity which is required to prepare consolidated financial statements for the MNE in its jurisdiction of residence. The large Israeli UPEs, with revenues exceeding NIS 3 billion (EUR 750 million) each year, will be obligated to file annual CbC Reports.
- **CbC Report** - Should be filed by the UPE in its state of tax residency for each taxable year and include two parts: (i) regarding each tax jurisdiction in which the MNE operates – revenue, profit (loss) before tax, tax paid, tax accrued, stated capital, accumulated earnings, number of employees, and tangible assets; and (ii) an identification of all constituent entities of the MNE by tax jurisdiction, together with their main business activities.

Proposed Section 85B - Burden of proof. According to the suggested law, the burden of proof regarding transfer pricing would be shifted from the reporting entity to the assessing officer only if the reporting entity meets all extensive reporting and documentation obligations. Importantly, this requirement includes a duty to provide practically any documentation requested in a tax audit including documentation that the local Israeli subsidiary may not have access to. This is a far-reaching requirement with the result that the burden of proof is likely to remain with the taxpayer and the ITA would seldom be required to produce its own in-depth transfer pricing analysis. This is consistent with the ITA positions in the recently published Tax Circular 1/2020 titled "Burden of Proof in Transfer Pricing".

Expected changes to current transfer pricing reporting requirements - Section 85A of the ITO. As of today, a party to an international transaction is required to provide the ITA with a transfer pricing study as well as certain details regarding the transaction, only if requested by the ITA to do so and within 60 days from receiving such demand. The proposed legislation would require preparing a transfer pricing study, both the Local File and the Master File, by the time of submitting the annual tax return, and provide it to the ITA upon demand. Transfer pricing studies will be significantly expanded to include numerous new details for both the Local File and the Master File. The Local File would be expanded to include the entity's organizational chart, a list of activities, changes of ownership and expected changes of ownership and a list of main competitors. The Master File would include expansive information with respect to the MNE, such as: a chart of the MNE's holdings (including geographic locations and forms of incorporation), a description of the supply chain, a list of service agreements within the MNE group, information regarding intangible assets, information regarding the MNE's financing, and the MNE's consolidated financial reports.

CbC Report. UPEs of MNE whose revenue is at least NIS 3 Bn will file an annual CbC Report (in English) within one year from the end of the taxable year. Under certain conditions, the ITA may also require a UPE report from an Israeli MNE member that does not meet the definition of UPE. As mentioned above, CbC Reports are intended to be shared with other countries as a part of the Multilateral CAA.

Initial thoughts and recommendations. The proposed legislation constitute a significant change to the Israeli requirements for transfer pricing documentation. The proposed Section 85B regarding the burden of proof, combined with the new extensive reporting requirements (especially the Master File report which would require an Israeli company to provide elaborated information concerning other foreign members of the MNE), will make it challenging to shift the burden of proof to the assessment officer and in our view was not required under the Multilateral CAA or the OECD "Guidance on the Implementation of Country-by-Country Reporting". Contrary to the ITA's position, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017) suggests a more practical and balanced approach such that "Taxpayers should not be expected to incur disproportionately high costs and burdens in producing documentation".

Even though the proposed legislation was published for public comments, we do not expect any major changes to the proposal. In addition, the approval of the proposal may still take some time and the effective date of the legislation is unclear.

Our firm has vast experience in advising multinational entities on properly setting the relationships between various group entities, putting in place proper documentation and manuals to support such structures, carrying out business model changes and in representing international and domestic clients before the ITA and the Israeli courts in transfer pricing controversies.

Contact Information

Eldar Ben-Ruby Partner Tax Group Leader	Meir Akunis Partner Tax Group	Shaul Grossman Partner Tax Group	Keren Shitrit Partner Tax Group
Dr. Michael Bricker Partner Tax Group	Omri Davidov Partner Tax Group	Nathalie Anvar Hammer Partner Tax Group	Nitzan Sarig Associate Tax Group

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