

Intercompany transactions – burden of proving arm's-length pricing

26 June 2020 | Contributed by [Fischer Behar Chen Well Orion & Co](#)

Transfer pricing
Tax circular
Comment

On 2 June 2020 the Israel Tax Authority (ITA) published a tax circular to clarify cases in which a transfer pricing study filed by a taxpayer will be considered to fulfil legal requirements and thus shift the burden of proof in the assessment process framework to an ITA inspector, in contrast to the general rule that the burden of proof rests with the taxpayer.

Transfer pricing

The operation of multinational enterprises presents complex international taxation issues, including the difficulty of determining the appropriate transfer pricing for transactions made by related entities, which plays a significant part in calculating the taxable income of each entity within the multinational group. The international transfer pricing standard, adopted by the Organisation for Economic Cooperation and Development, is the arm's-length principle according to which intercompany transactions should be done at market rates (ie, having the same terms and conditions which would have been agreed had the transaction been made between unrelated entities). Section 85A of the Income Tax Ordinance (5721-1961) adopts this standard, determining that an international transaction between related entities should be reported, for tax purposes, as if it were made at market rates. Section 85A states that if a taxpayer provides to an ITA inspector, on the latter's request, a transfer pricing study and supporting documents, the burden of proof will rest with the ITA inspector if they prescribe anything that differs from what was agreed between the parties.

Tax circular

The tax circular lists a number of cases that would prevent the shifting of the burden of proof to the ITA inspector, including that:

- the transfer pricing study does not include all relevant documents as required in accordance with the Income Tax Regulations (Determination of Market Conditions) 5767-2006;
- the conclusions set out in the transfer pricing study are not properly supported by the evidence presented in the study;
- the transfer pricing study is not adequately comprehensive and exhaustive; and
- the taxpayer did not deliver documents which were required by the ITA inspector during the tax audit.

In addition, the tax circular emphasised that the mere filing of a transfer pricing study does not shift the burden of proof to the ITA inspector regarding the facts on which the transfer pricing study is based (ie, to the extent that the supporting facts of the transfer pricing study are disputed, the burden to prove them rests with the taxpayer).

The tax circular further provides that where a transfer pricing study is not filed or where a transfer pricing study is filed but does not satisfy the requirements of the Income Tax Ordinance and the Income Tax Regulations, the ITA inspector may set a tax assessment according to their best judgment, without the need to carry out a transfer pricing study on its behalf. In such cases, it may be difficult for the taxpayer to challenge the ITA tax position due to lack of information enabling it to compare and analyse the relevancy of the analysis performed by the ITA inspector.

Comment

If taxpayers meet the requirements set out in the Income Tax Ordinance and the Income Tax Regulations, as discussed above, the burden of proof will shift to the ITA inspector, who will be

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required to prove their calculation with clear and convincing evidence to the balance of probabilities standard.

Arguably, the tax circular undermines the legal burden of the ITA inspector to justify their assessment where it deviates from the taxpayer's transfer pricing study; however, in order to avoid a discussion on the burden of proof, multinational groups should substantiate the transfer pricing between group entities with supporting facts and evidence and ensure that transfer pricing studies are properly documented.

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