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Tax News Alert No. 6

Dear Friends and Clients
We are pleased to update
you will selected Israeli
tax development for the
fourth quarter of 2009.

Selected Issues:

- The Economic Enhancement Program – Windows of Opportunities - Dividend Distributions at 12% Benefit - Temporary Provision.
- Real Estate Taxation - the day of purchase for apartments given as exchange in a combination transaction – the Shadami rule.
- Deductible Expenses - not on illegal payments
- International taxation - family company and benefits for new immigrant

Sincerely,

**Artzi & Hiba
Tax Solutions
Ltd.**

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Tax News Alert
should not be
regarded as a tax
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Tax News Alert No.6 - December 2009

Dear friends,

We are pleased to send you our warmest greetings and best wishes for the New Year 2010.

We would also like to thank you for using our services and for your kind cooperation which enables us all to offer the best tax solutions. It would be our professional as well as our personal honor to continue cooperating with you.

Happy New Year from all of us at Artzi & Hiba.

The Artzi & Hiba firm is committed to the highest level of services.

We keep our clients and colleagues, in Israel and abroad, fully up to date with respect to Israel's tax law developments and their implications.

We are pleased to provide you our sixth Tax News Alert. This Alert focuses and highlights significant Israeli tax law developments of recent months.

The Economic Enhancement Program -a Window of Opportunities - Dividend Distributions at 12% Benefit - Temporary Provision

Under the Economic Enhancement proposal for 2009-2010, published on July 2009, a temporary benefit provision was determined, as an incentive for distributions of profits from Israeli company. Currently, under certain conditions, distributable profits accumulated until 31.12.02 are entitled to a low 10% tax rate in the event of selling the shares or dissolution of the company. According to the provision, dividends originated from distributable profits accumulated until the "determining date" (31.12.02), and distributed from October 1st, 2009 until September 30, 2010 ("The Benefit Period"), will be charged at a 12% tax rate instead of the regular tax rate of 25% (or 20% for a shareholder holding less than 10% of the distributing company).. In order to receive the

abovementioned reduced tax rate, 4 cumulative conditions must be met:

1. The dividends were paid within the benefit period- it should be considered when possible, to delay dividend distribution, whether as an actual distribution or as part of an agreement with the Israeli Tax Authority ("ITA"), in order to be able to benefit from the reduced tax rate of 12%.
2. The shares of the distributing company were purchased until the "determining date"-before January 1st, 2003.
3. The recipient of the dividend would have been entitled to distributable profits at 10% tax rate benefit as mentioned above.

4. The average income from the company that distributes the dividends remains unchanged - the shareholder's income in the years 2009-2012 from salary, interest, linkage differentials or other payments from the distributing company mustn't be reduced compared to the income average received by the shareholder during the years 2007-2008. When calculating the income for the years 2009-2012 the reduced dividend rate will not be taken into account according to this section.

This provision takes out of context many possible situations as follows:

- a. A company that stopped producing an active income by the end of 2008, won't pay its shareholders any kind of salary during the years 2009-2012, and as a result, won't stand up to the income average exam.
- b. The sanction for when the income average exam is not being held is not defined as a relative sanction and so, even a 100 NIS excess from the

average income may rule out a benefit for the entire dividend.

To conclude, this temporary provision is blessed in its essence but the implementation of it is not simple. It raises countless number of methods and many arguments regarding the distributable profits. It is advices before distribution to examine the dividend sum. In addition there are several steps needed to be executed already in 2009 in order to create a high standard platform for effective use of the above mentioned benefit.

We think that the legislator should reconsider the abovementioned provisions. Meanwhile, advisers should be cautious in what they advise a withdrawal at 12% that may end with paying 25% and wasting the 10% tax rate benefit forever.

Real Estate Taxation - The Day of Purchase for Apartments Given as Exchange in a Combination Transaction - The Shadmi rule

After a further hearing the Supreme Court finally the Shadami rule was ratified (case 6811/04 ,dated 4/8/2009). The case that was discussed in Shadami deals with the day of purchase in combination transaction (i.e. a transaction where the property owner

sells a part of his rights in the property to a contractor in exchange for building services the contractor provides him), and it has considerable importance.

As we know, a preliminary condition for tax exemption on the betterment tax when selling a residential apartment is

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that the seller sold all of his rights in the residential apartment (Article 49a(a)). In the most common combination transaction, only a part of the apartment is sold and nevertheless, the owner wants to get his exemption for the entire apartment. The **Ben Ami ruling** determined that in this case, a tax exemption would be given to the owner. Even before this ruling, the law was changed (amendment no. 8, 1980), and the owner of the combination was given the opportunity to choose between waiving the exemption entirely or receiving the betterment tax exemption (taken from the total return calculated) on the entire apartment value and additional buildings rights as mentioned in article 49(g).

The Closing of such circle is made on the day the owner would sell the apartments he received in the combination transaction for the property part that remained with him. The discussion in Shadami referred to this purchase date:

The director of real estate taxation claimed that, because we are dealing with a partial sells, the part that stayed with the owner was not sold to the contractor. Therefore, when the

Deductible Expenses - Not on Illegal Payments

In continuation with our last tax news alert (no.5), regarding the bill proposal to prevent the deductions of illegal payments as a recognized expense for tax purpose, we would like to inform that, On November 26, 2009 subsection (16) was added to article 32 of the Israeli Tax Ordinance (that deals with deductions

apartments that were built on that property were sold, the day of purchase and the purchase value is the historical date of when the property was bought and accordingly the purchase date.

On the other hand, Shadmi claimed that, due to the fact that in the betterment calculation of the partial sale transaction, the betterment was calculated with addition to the worth of the property that was not sold. Thus, the day of purchase as well as the purchase value of the apartments on that property part had to be the day of the combination. Otherwise, a double Taxation will accrue.

Shadmi's approach was supported by six Supreme Court judges, stating that when a seller sells the apartments he got in exchange, there is no need to tax him again for the betterment referring to the rest of the property: ***"After applying a fiction regarding the owner, that results in betterment tax payment as if he sold the entire property to the contractor, we must continue to apply this fiction even when the apartments he got in exchange are being sold"***.

that should not be granted), stating that: "payments, whether given in cash or money equivalent, that have reasonable basis to assume they constitute an offense under any law".

To be clear, the tax authority should enforce this subsection only when the

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payment itself is illegal (such as in bribery payments), and not when there is an illegal act that is associated to the payment (for example: paying an employee that is staying in Israel illegally- the payment in itself is legal and therefore will be deductible).

With respect to the wide discretion given to the tax assessor, in classifying certain expenses as illegal per se, we think that the implementation of such power should be much more complex. For comparison, in section 291a of the Penalty law that talks about bribery, in order to establish the bribery offence, consent from the Attorney General is required (a power that up until today was not delegated to another person). Moreover, in order to determine whether

to open an investigation in this case a decision from the head of the inquiries and intelligence department is required (after he has informed the Attorney General in his decision), whilst in our case the tax assessor is qualified to establish reasonable basis without having to get consent from a higher jurisdiction.

As we can see, this wide discretion was given to the tax assessor without any clarifications or guidelines to follow. It may lead to a result where a civil tax assessor decides on criminal matters. **It is in our opinion, that that was not what the legislator was aiming for and therefore the tax assessor must proceed with much caution when dealing with this subsection.**

International Taxation - Family Company and Benefits for New Immigrant

Recently an interesting taxation resolution, referring income from a family company to a new immigrant was published (Taxation resolution 1010/09).

The case dealt with a couple, residents and citizens of a treaty country that considered immigrating to Israel and getting the status of "new immigrants". The couple owned a foreign company (fully held by them) which serves as an "agent" to another foreign company that was a related company. The couple wanted to incorporate a family company (i.e. a transparent entity for tax purpose) in Israel that will replace the "agent"

company's activities. The family company would commit to tax under Section 64 A of the Ordinance .

The question was whether the couple is entitled to the benefits in accordance with Article 14 (a) of the Ordinance, even when the activity producing the income will be through the Israeli family company. Section 14 (a) of the Ordinance provides for a 10 years tax exemption on income produced outside of Israel by a new immigrant ("Olim") or a long term returning resident, including income from business activity. Exemption is determined pursuant to Section 14 (a) and

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pursuant to Section 97 (b) (regarding capital gains), as applicable, and shall apply, **as long as the family company's income was produced and accrued outside of Israel.**

This decision is recommended from a taxation point of view, especially given that in terms of the Israeli tax system, the tax result would have been similar if the couple continued working through the foreign "agent" company they owned (that already existed or through a new

company). However, implementation of this resolution may improve the tax outcome in foreign countries where the activity takes place.

It should be noted that this decision allows extensive use and creativity regarding the benefits that are given to new immigrants or a long term returning resident, combining family companies and using this taxation decision.

In case you have any questions or need further clarifications please do not hesitate to contact our International Taxation Team:

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