✓Artzi & Hiba - Tax Solutions Ltd.

Tax News Alert

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Tax News Alert

Dear Friends and Clients
We are pleased to update you will selected Israeli tax development for the first quarter of 2010

Selected Issues:

- New treaties between Israel and Estonia, Vietnam and Taiwan
- Tax treaties from the Social Security standpoint
- An Israeli company as a company of a preferable tax regime
- A hidden advantage -the representative taxpayer in a "Family Company"

Sincerely,
Artzi & Hiba Tax Solutions Ltd.

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Dear friends,
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 would 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 Passover from all of us at Artzi & Hiba.

New treaties between Israel and Estonia, Vietnam and Taiwan

These days, the ordainments bringing the new treaties into force, as of January 1st, 2010, were signed. The new treaties are designed to improve the competing ability of many Israeli companies, operating in these countries over the past years, in areas such as technology and communications and to encourage mutual investments.

Important Principles in the New Treaties:

Individual Residency Ties Breaker:

In the treaties with Vietnam and Taiwan, the first test to determine the individual residency, in case he is considered as resident in both countries, is the "Center of vital interests", instead of the "permanent residency", as usually accepted as the first test in the OECD model.

Since this exam very widespread and can't provide the certainty needed to determine the individual's residency, it may result in turning to mutual agreement procedures between the two countries in an early stage, which may bring the residency issue to be "hanging on the fence" for a while.

Corporate Residency Ties Breaker:

In the treaty with Estonia, in an event of a dual resident of a corporate, the authorized authorities of Israel and Estonia will try to settle this matter in mutual agreement procedures and not by the "effective management" exam as usually accepted in the OECD model. The treaty protocol indicated that in such an event, factors like "the actual place of management", "the place of incorporation" and other relevant factors will be taken into account. In addition, if and when Estonia adopts the "effective management" criteria as its residency exam, the treaty will naturally adopt it as well. Unfortunately, as long as there is unclarity in this matter, there might be situations in which the corporation will have to pay double tax.

Indirect Credit in Mitigating Conditions

The new treaties with Estonia and Vietnam determine that when dividend are being distributed between companies, and one has a hold of 25% or more in the distributing company's share capital, the indirect credit will take into account the corporate tax paid for the income in which the dividend was distributed from. **Hence, it is sufficient for an Israeli company to hold 25% of the distributing company's share capital in order to receive the indirect credit**. According to the Israeli tax authority's interpretation, in the absence of a special provision in the treaty **the 25% holding should be in each and every "means of control":** the right for profit, the right to appoint a director or a CEO, voting rights etc'. As we can see, the condition in the treaty is mitigating with this rule.

Most Favorable Nation Rules (MNF).

In the new treaty with Taiwan when it comes to dividends and royalties the maximum tax rates are 10% in the country of origin, when in the treaty protocol a MFN rule is applied, accordingly if Taiwan signs a treaty with an OECD country, where the tax rate on dividends and\or royalties is lower than 10%, the new rate will automatically be applied in the treaty between Israel and Taiwan. We will keep you informed.

Trusts

In the new treaties there is no reference to the trust subject, which is very unfortunate, as it leaves the uncertainty in regards to "transparent bodies". As we know, In the new treaty between Israel and the U.K. this subject was specifically addressed.

Technical Services

In the treaty with Vietnam there is a reference to management and consulting services, when the maximum tax rate is 7.5% in the country of origin. Accordingly, management and consulting services from an Israeli resident paid by a Vietnamese resident will be subject to tax in Vietnam, even if the service was given in Israel. It should be noted that the tax paid in Vietnam will be creditable in Israel.

We would be pleased to assist you with any clarifications and explanations, as may be required.

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Tax treaties from the Social Security standpoint

Israel is signed on social security treaties with many countries. These treaties regulate the social security rights of who ever emigrates from one country to the other to live there temporarily or permanently.
The types of insurance regulated in the treaties are as follows: old-age, survivors, children, work injury, maternity, general disability etc'

Important Principles in different treaties:

1. When an Israeli employer sends his employee to work abroad in a treaty country- the Israeli employer has to continue and pay both national security and health insurance in Israel, for the employee, according to the national security law. The employee is exempt from paying the national security in the treaty country. The exempt period is determined according to a special arrangement in the treaty.
2. An independent worker or a salaried employee for a foreign employer in a treaty country- the insurer pays the national security in the treaty country. According to the provisions of the treaty he will be exempt from paying national security in Israel. Despite that fact, he will still have to pay the health insurance in Israel throughout his stay abroad. The insurer has to address his local national insurance institution, according to his living area, to arrange the payments.
3. Public service employees, airline companies and diplomats- the employers of employees, who are sent to work in a treaty country, have to pay national security and health insurance in Israel, with no limitation period. The employees are exempt from paying these payments.
4. A foreign employee of a treaty country that comes to work with an Israeli employer- as of January 1st, 2010, there is an obligation to report on these employees as on regular Israeli employees, excluding health insurance. The employee has to continue and pay his health insurance in his own country.
5. A foreign employee of a treaty country who is sent by a foreign employer of a treaty country- if the foreign employee has a legal delivery address in Israel, the same rules of an Israeli employer will apply. If there is no legal delivery address in Israel, the employee will have to pay his own social security. In any case since health care does not apply on foreign employees, he has to pay it individually.

Other issues regulated in the social security treaties:

- Export allowances, which allow allowances payment the insured is entitled to, even in the other country.
- Combining periods of insurance in both countries, to enable the realization of rights and payments of pensions.
- Medical hospitalization: after an injury at work or for giving birth.

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A hidden advantage -the representative taxpayer in a "Family Company"

According to section 64a to the Israeli income tax Ordinance, a family company is a company that its shareholders are all family members, who, according to the section, are seen as one person. From the tax standpoint, the income of the company is seen as if it was all produced by the "representative taxpayer", unlike in a partnership, where the incomes are attributed to all the members, according to their proportional hold in the partnership
Let's take for example two brothers. One is an Israeli resident and the other is a foreign resident. The two brothers incorporate an Israeli company that applies to

be considered as a family company. The foreign resident brother has most of the rights for profits in the company, so he is considered as the "representative taxpayer".
Let's also assume that the company has a capital gain from selling Israeli securities traded in the Israeli stock exchange. In light of the fact that the company's profits are attributed to the "representative taxpayer", who in this case is a foreign resident, and since he is entitled to an exemption from paying tax on capital gain in Israel, when selling securities, **it could be claimed, that all the capital gain would be exempt from tax in Israel.**

A similar outcome would be when the company receives capital gain from realizing its investments in Israeli companies. This kind of investment structure can have even wider effect. For example**, when a family company, that its "representative taxpayer" is a foreign resident, invests overseas. It could be claimed that the company would not be liable for tax in Israel, The same claim can be ascribed in different cases to veteran resident or a new immigrant that act as the "representative taxpayer".** Our firm has much experience when dealing with such structures.

An Israeli company as a company in a preferable tax regime.

A Trust Holding Company ("**Trust Company**") is defined in the trusts section in the Israeli Income Tax Ordinance as:

> **"A body of persons holding the trust assets for the trustee, directly or indirectly"**

The definition indicates that the trust company is transparent and serves as a "vessel" to hold the trustee assets.

The trust company has no obligation to submit annual reports to the Israeli Tax Authorities ("**ITA**"), and naturally is not subject to tax in Israel. The report requirements and the tax liabilities, if any, are on the trustee. In some cases it might be imposed on the settlor or one of the beneficiaries.

The characteristics of such a company, established legally in a country without any requirement to report or pay tax in that country, has some resembles to the characteristics of a company incorporated in a preferable tax regime.

Although the State of Israel is not considered around the world as having a preferable tax regime characteristics, in the framework of the trust legislation, which is in force since 1.1.2006, a company with these characteristics was in did recognized.

An interesting use with a "trust company" can be done by foreign residents that hold and manage assets (mostly assets abroad), without having to report to the ITA. Under the assumption that there is a double taxation treaty between Israel and the state where the business activity occurs, it may be claimed that since the company is resident in Israel, the provisions the treaty must be applied. One of the explanations to this claim is that body of persons is defined as "Resident" in the treaties and the abovementioned company is a resident of Israel. The ITA standpoint in this case is that the tax treaties provisions do not apply in connection to the "Trust Company", due to its unique characters, as mentioned in the trust section, in the Israeli income tax ordinance.
To conclude, a "trust holding company" may be incorporated in Israel and despite that fact- would not be required to report and pay tax, meaning that it would act as a company in a preferable tax regime. Many uses may be preformed with such a company- mostly by foreign residents who seek for companies incorporated in common tax regime countries, in opposed to tax regime countries that are considered as unacceptable.

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

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