✓Artzi & Hiba - Tax Solutions Ltd.

Tax News Alert

7 Menahem Begin st., Ramat-Gan 52681, Israel. Phone: 972-3-6134111. Fax: 972-3-6133113
Web site: www.artzi-hiba.co.il E-mail: artzi@artzi-hiba.co.il

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Tax News Alert No. 8

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

Selected Issues:

- Benefits to a New Immigrant When Purchasing 2 Apartments in Israel
- Denying Rights to a Foreign Company Being Held By a New Immigrant or Veteran Resident
- Investing Through an Israeli Holding Company In Light of the New Tax Treaties Israel has Signed lately
- New Tax Treaty with Georgia

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Dear colleague of the Alliott Group,
Alliott Israel with the collaboration of its tax department, Artzi & Hiba – Tax Solutions Ltd., are 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.

Benefits to a New Immigrant When Purchasing 2 Apartments in Israel

As part of the benefits a new immigrant receives, he is entitled to a reduced purchase tax rates. This in accordance to the real estate taxation regulations (betterment, sale and purchase)-1974, indicating that a new immigrant would pay a reduced purchase tax of 0.5% up to a limit of about 1.4 million NIS. Beyond that limited amount, he would pay 5% tax. The benefit will be granted to the new immigrant just as long as the apartment was purchased within 7 years from the first day he arrived to Israel for the first time or a year before he immigrated to Israel.

The reduced purchase tax, as indicated above will apply when purchasing (1) a residential apartment, or an apartment used for residential and business purpose together, so that the new immigrant can use the apartment to reside in it or to reside and work together in that apartment; (2) a business, including an agricultural farm, for the use of the new immigrant or his relative; (3) vacant ground under certain conditions…". **It should be noted that the regulation applies on whatever real estate right the new immigrant would purchase, within the benefit period, as mentioned above, meaning, once for a residential apartment and once for a business. In addition, it is important to emphasize that the regulation does not limit the benefit to a purchase of a "sole apartment".**

A sole apartment has a special and separated reference in the real estate taxation law, accordingly, an individual who purchase an apartment and it is his "sole apartment", would be entitled to a significant relief on the purchase tax rates as follows: up to an amount of about 1.1 million NIS he would pay no tax. For any amount between 1.1 million NIS to 1.5 million NIS he would pay 3.5%. Beyond that amount he would pay 5%. **This benefit is given to either an Israeli resident or a foreign resident.**

In light of the above, an interesting outcome may arise in the following situation: the new immigrant purchase a sole apartment in Israel whilst he is considered as a foreign resident and later on purchase a second apartment in Israel. In regards to the first apartment, he would enjoy the reduced tax rates according to a "sole apartment", as mentioned above (0%; 3.5%; 5%). In regards to the second apartment, he can use the purchased tax relief rates according to the regulations mentioned above. This, instead of paying the regular purchase tax rate on the second apartment: 3.5% up to a limit of about

923 thousands NIS and 5% above that limit amount. Note that in the event that the new immigrant decides not to purchase a second apartment, he can apply for a tax refund on the gap created between the tax he paid as a foreign resident and the tax he would have paid as a new immigrant. This pending to him immigrating to Israel within a period of one year since the first day he purchased the first apartment.

Denying Rights to a Foreign Company Being Held By a New Immigrant or Veteran Resident

Amendment 168 to the ITA was designed mainly to absorb immigration to Israel; to bring back human capital and to encourage financially capable investors to become Israeli residents.

Within this amendment different provisions were added "to preserve the new immigrants and\or veteran residents (hereinafter: **"beneficiary individuals"**) rights **so they will be considered as if they remained foreign residents for a period of 10 years"** (see amendment commentaries)**.** Example to this can be found in the control and management rules, the CFC rules, the FVC Rules, the Trust and Foundation chapter etc'.

however, it seems that amendment 168 skipped provision 68a, referring to a foreign resident body of persons that will not be entitled to any tax benefit, relief or exemption, for being a foreign resident, if an Israeli resident has control shareholding or is considered as a beneficiary, directly or indirectly, of 25% or more of the foreign resident body of persons income or profit. Beneficiary individuals were not excluded in this provision; **hence an undesirable outcome occurs in which the rights of a foreign company that is held by a beneficiary individual are being denied**. We believe that this situation represents a lacuna in the law and as such, may have significant implications on other provisions in the ordinance as we show in the following situations. Note that the situations mentioned herein may apply only in countries where Israel did not sign on a tax treaty (i.e. Australia, New Zealand, Cyprus etc'). In the event that a tax treaty exists between Israel and the other country, we believe that the treaty provisions will overcome provision 68a:

1. An individual that holds shares in an Israeli company through a foreign company arrives to Israel and is considered as a beneficiary individual. When selling the shares of the Israeli company, the foreign company will be denied from the exemption benefit due to provision 68a to the ordinance, as mentioned above. This exemption benefit would have been given to the individual if he had remained a foreign resident. It should be also noted that the benefit is given to the beneficiary individual but not to the foreign company held by this beneficiary individual
2. A foreign resident with a foreign company that holds an Israeli participating exemption company. The foreign company will be subject to a limited tax rate of only 5% when receiving dividends from the Israeli company. However, when the foreign resident becomes a beneficiary individual, the foreign company will be subject to the regular Israeli tax rates of 20%-25% and even to a deemed dividend.

A solution to these problems may be found by **transferring the foreign company to a family company, so that its income, including the**

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

With respect to any query please refer to Ms. Gila Assayag
Tel: 972-3-6134111.
Fax: 972-3-6133113
E-mail: gila@artzi-hiba.co.il

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profit from the realization of the Israeli company's shares, would be attributed to the beneficiary individual. This way, to our opinion, the individual will be entitled to the exemption, assuming that the shares are not quoted (this, inter alia, in light of the ITA's latest position that it is possible to attribute the family company's beneficiaries the benefits given to a new immigrant, who is considered as a beneficiary individual (see tax decision No. 1010/09).

* Investing Through an Israeli Holding Company In Light of the New Tax Treaties Israel has Signed lately

Similar to other countries around the globe that have a participation exemption regime, Israel has regulated participation exemption rules in relation to an Israeli holding company. Such company enjoys different exemptions, among others, exemption on capital gain when selling the shares of the companies it holds, exemption on dividends distributed from the companies it holds, exemption on dividend, interest and capital gain from quoted securities in the Israeli stock exchange, exemption on interest and linkage differentials the company received from a financial establishment etc'. Furthermore, dividend received by a foreign resident shareholder, from an Israeli Holding Company would be subject to only 5% tax rate. This section, though trying to encourage foreign residents to invest through Israeli companies still has somewhat of a deterrent factor. In this context, we see that in some of the recent tax treaties Israel has signed (with the U.K., Denmark, Belgium and Georgia), there is a tendency to lower the tax rates and even grant a full exemption in the source country on dividend distributions in case of a substantial holding of 10% or more by the parent company. As a result, Israel's taxation status becomes equal to other countries giving an exemption in this case. Moreover, the fact that Israel is an advanced country with a worldwide activity and a diverse number of tax treaties, improves its attraction for foreign investors to invest through an Israeli holding company.

New Tax Treaty with Georgia

The treaty between Israel and Georgia was signed in May 12, 2010. Like other new treaties Israel has signed lately (see tax alert No 7), this treaty sets out rules that enables Israel's Competing abilities on an international level, as well as to encourage mutual investments. The treaty should enter into force on January 1st, 2011.

<u>**Important Principles in the New Treaties:**</u>

Individual Residency Tie Breakers:

When a double residency issue arises between Israel and Georgia, the residency should be determined according to the tie breakers exams as set in the OECD model. The exams are set in a hierarchy order as follows: The first exam set to determine one's residency is the "permanent residency" exam. The second exam is the "Center of vital interests" (similar in its essence to the "center of life" exam set in the Israeli internal law). The third exam is the place of "habitual abode". The forth exam is determined according to the individual's nationality.

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Further, if the residency status cannot be determined the two countries will turn to mutual agreement procedures.

Corporate Residency Ties Breaker:

In an event of a dual residency of a corporate, the matter would be resolved by implementing "the place of effective management" exam (similar to the control and management exam), as excepted in the OECD model.

Permanent establishment

The treaty provisions determine that a building site, construction or installation project constitutes a permanent establishment only if it lasts more than nine months.

Dividends

According to the new treaty there will be no withholding tax ("**WHT**") on dividend distributions in case of a substantial holding of 10% or more by the parent company, and 5% in all other cases.

Interest

According to the new treaty there will be no WHT on interest paid to one of the contracting country by the other country (state bonds), pension plans etc'. In other cases the rate will be 5% (like when paying interest between companies in these two countries)

Royalties

As in Article 12 of the OECD Model, no WHT will apply. We would mention at this point that according to Georgia internal law, royalties are subject to 10% tax rate.

It should be noted that the treaty provisions relating to dividend, interest and royalties refer to the "Beneficial Owner".

Indirect credit

According to the treaty, when dividend are being distributed between companies, and one has 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. This is similar to the provisions set in the new treaties Israel has signed with Estonia and Vietnam. We remind that 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 it seems, the condition in the treaty is mitigating with this rule

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

Advocate and CPA Hagi Elmekiesse (hagi@artzi-hiba.co.il)
Advocate and CPA Gadi Alimi (alimi@artzi-hiba.co.il)
Advocate Lilach Asherov (lilach@artzi-hiba.co.il)
Advocate Eti Goraly-Halman (eti@artzi-hiba.co.il)