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Tax News Alert No. 13

Dear Friends and Clients
We are pleased to update you with selected Israeli tax development for the last quarter of 2012

Selected Issues:

- Management and control from Israel – a landmark case and guiding principles (Niago case)
- Individual income tax – consolidated / separate calculation: Malkieli ruling
- Two Tax Treaties cooking with Malta & Panama

Sincerely,
Artzi & Hiba Tax Solutions Ltd.

Tax News Alert No.13 - April 2012

Dear friends,

We take this opportunity to send our wishes to you all, on the occasion of the Passover Holiday. According to the Hebrew tradition, this holiday signifies human freedom and, according to the Bible, marks the beginning of spring in the Holly Land.

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 recent developments in the Israeli tax law and their implications.
We would like to thank you for using our services and for your kind cooperation which enables us to offer you high level tax solutions. It would be our professional, as well as our personal, honor to continue cooperating with you.

Management and control from Israel - a landmark case and guiding principles (Niago case)

On 12 January 2012, the Israeli District Court of Appeals (case n° 1029/00), published a ruling which highlights the guiding principles on when a company established abroad will be considered to be Israeli resident for tax purpose, as far as the management and control of its business are conducted in Israel. In this case, shareholders of an Israeli company (the "**Israeli Company**"), engaged in export of textile products, established in 1990 a foreign company in the Bahamas (the "**Foreign Company**") and transferred to the latter the Israeli company's activity regarding non-Israeli customers. It should be mentioned that three years later, the Foreign Company sold back the activity to the Israeli Company, resulting in a substantive tax benefit for the Israeli shareholders according to the Israeli Tax Ordinance ("**ITO**"), as formulated before the implementation of a worldwide tax system in Israel.

According to appellants (the Israeli Company and its shareholders), the Foreign Company's business was conducted by managers and employees living outside Israel: the foreign board included three non-Israeli members; board meetings were held outside of Israel and the decisions of the board

were made by the directors independently without involvement of the Israeli Company or its shareholders; the foreign directors had thorough knowledge of the relevant activities; the Foreign Company's head office and two other offices were located outside Israel; the orders from around the world, the financial management and the issuance of receipts and letters of credit were all made from the Foreign Company's offices abroad. The Israeli Tax Authority ("ITA") argued that the management and control of the Foreign Company were carried-out in Israel. Further alternatives claims were argued, including artificiality of the acts according to the general anti-avoidance rule set up in Article 86 of the ITO. The court examined the evidences and facts and ruled that the Foreign Company should be seen as a company whose business is managed and controlled in Israel and accordingly, as an Israeli-resident company for tax purpose. The main principles arising from the contemplated case are discussed henceforth:

<u>Foreign Company's activity</u> - prior to the establishment of the Foreign Company, the activity with foreign buyers and Israeli manufacturers was performed through an independent agency in the U.S. (run by an American individual); therefore, there was no substantial need of the Foreign Company's existence. The ruling emphasized that under the circumstances, the facts indicate that: "a corporate mechanism that includes board, offices, bank accounts and so forth, is not enough to indicate that there is an independent corporate entity separated from the Israeli Company and/or the appellants. Such mechanism may constitute an artificial platform..."

As was following discussed, the Foreign Company has not provided the professional tools required for the contemplated marketing activities. Moreover, the Foreign Company's business was partially conducted in Hebrew, which is not spoken by its managers nor by its employees, and actually were lying on business communication and documentation transferred between the Israeli Company and the independent agent.

<u>Independent agent's activity</u> - in this case, there was no difference, whatsoever, between the agent's activities prior to the establishment of the Foreign Company and afterwards. He continued to work with the Israeli Company, without any involvement of the Foreign Company's managers and employees, including the determination of fees received by each of the factors involved in the said business. Apparently, this fact reinforced the Court's statement that the Foreign Company's establishment was of an artificial nature.

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Conduct of managers and employees - the evidences presented to the court showed that the Foreign Company's directors were not engaged in daily activities for and on behalf of the company and had no real knowledge about its business activity. During his investigation, one of the directors couldn't mention not even one of the manufacturers' names with whom the company was associated. Later, the ruling stated that: "**even if one of the directors was engaged in daily administrative activity, after all, it doesn't suffice for demonstrating a real management support of the company.**"

Shareholders' behavior - ITA Circular nº 4/02, dealing with guidelines for management and control's determination, provides that one should examine who is the factor managing and controlling the business's activity: in the case that strategic decisions are not determined at the company board level, the shareholders are presumed to be the decision makers. In this case, one of the shareholders (an Israeli resident), confirmed that him and the other shareholders decided whether to engage with a customer suggested by the independent agency - a fact that contradicts the appellants claim. The facts further indicate that decisions regarding policy management and contractual agreements were made by them rather than by the Foreign Company's managers (we would mention merely that management and control is conducted where the directors carry out their powers, regardless their residency).

Protocols and documents - the ruling emphasizes the importance of what is written in various documents. In this case, the facts showed that no significant decisions were made by the Foreign Company or by its managers. Documented decisions were short and laconic, without any relevant discussions or comments regarding the issues that were allegedly on the agenda. Judge *Altoviah* noted that "**in matters relating to the Foreign Company's business existence, the protocol should reflect how the decisions were made and if the participants relied on any expert reports, this fact should have been reflected in the protocols.**" With this regards, previously mentioned ITA Circular 4/02, emphasizes that in order to locate the place where strategic decisions are made, it is important to examine the decision making process as a whole. That is, one should examine where decisions were essentially made and not only the place were technical formalities were performed, when generally; the process of significant decisions is not shaped at a specific time.

In our opinion, the discussed ruling was given in response to the "full picture" which involves a quite radical

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tax planning and behavior, in addition and regardless of the management and control issue: the judge explicitly states that "The sale back of the company's business to the Israeli Company and the transfer of the dividend to the appellants was made with a main purpose of avoiding tax or reducing it inappropriately." After all, it appears that the ruling's was aimed to "repair" the distortion that was (artificially) created. It should be mentioned that the ruling deals with a daily and acute international tax issue in which an Israeli court decision hasn't been given for more than twenty years, since the "*Solel Boneh*" supreme-court decision in 1994. However, the contemplated last ruling is a District Court ruling, and therefore, is not considered a binding precedent.

Individual income tax - consolidated / separate calculation: Malkieli ruling

On February 1st, 2012, the Supreme Court issued a new ruling regarding the individual taxpayer's entitlement to consolidated or separate calculation of the tax liability of the taxpayer and his\her spouse (the Malkieli case). It should be emphasized that in a separate calculation, each spouse's tax liability is determined separately (including the entitlement of credit points and lower tax brackets) and usually that kind of calculation is favorable to the taxpayer. The Malkieli case set a new binding precedent, which changes a previous ruling from 2003 (the Keles ruling).

The appeals deal with three married couples. In each of the cases, the spouses were working at the same company, while at least one of them is holding 96% - 100% of the company's shares.

The couples claimed the separate calculation approach in their tax returns, as it were, despite the alleged dependence between the sources of their income. According to the taxpayers, they demonstrated both the necessity of their employments and the implementation of the arm's length principal on their wages. Since all concerned couples were employed in companies controlled by them, the assessing officers determined that, despite Keles precedent, the spouses' incomes were dependent and therefore, an assessment was issued according to the consolidated calculation approach.

The court analyzes the legislation regarding tax calculation: paragraph 65 of the Israeli Tax Ordinance ("**ITO**") states that both spouses' incomes are considered as the income of the "registered spouse". Paragraph 66(a) of

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the ITO allows a separate calculation for the unregistered spouse for his/her income derived from personal exertion, a profession or employment. Separate calculation entitlement is restricted by paragraph 66(d) of the ITO, which sets conditions to be met. According to the court's opinion, that paragraph is to be divided into two separate parts:

3. First, the spouses' option to separate calculation is denied if generally, their incomes are "dependent". The intent is to examine the ability of one spouse to decisively influence on the other spouse's employment's conditions and salary.
4. At a second separate stage, enumerates three conclusive presumptions, in which cases the spouses' incomes are deemed to be dependent.

The court attempts to distinguish his decision from the Keles precedent, which stated that the three presumptions mentioned above are rebuttable presumptions. However, a profound reading of the new ruling shows that the court sets a new precedent: according to Keles ruling, the end of the paragraph mentioned above has a subjective purpose of "preventing tax reduction" and an objective purpose of "realization of the right to equality" (preventing discrimination between couples and individuals etc.) The outcome of that second purpose is that the presumptions are rebuttable and therefore, the independence between the two spouses' incomes can be proved in order to implement the separate calculation approach. However, the Malkieli ruling reaches an opposite position, stating that the wording of the law clearly shows that the presumptions are conclusive and not rebuttable ones, and that it is hard to think of a reasonable interpretation of the contemplated paragraph which finds a basis for the argument that a separate calculation can be implemented while the spouses' incomes are dependent. The ruling emphasizes that indeed, a tax law can be interpreted according to its purpose, but a preliminary condition for such interpretation, is the existence of a foundation to such interpretation in the wording of the law.

Therefore, according to the ruling, paragraph 66(d) must be narrowly interpreted, i.e. denial of the separate calculation for the spouses when the circumstances fit one of the enumerated presumptions, even if there wasn't any intent of tax reduction.

We note that at the end of the verdict, court determines a vague "fact": *"Therefore, because there is no dispute that there is dependence between incomes when the couple holds 100% of a family company, and because there is*

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no doubt that In such a situation, the salary level of each spouse is affected by the other spouse's wage and decisions, it must be determined that their incomes are to be calculated jointly."

Despite the harsh ruling, the Court finds that the legislator should amend the law: *"One can hope that the legislator should consider whether the wording of paragraph 66(d) of the ITO is still relevant today, 55 years after its legislation... This is a clear case that shows the distance between the existing law and the desired one... no need to add tax considerations to the list of reasons that weaken the family unit. This is a law that in certain circumstances creates a discrimination against married couples by granting tax advantages to unmarried couples."*

Two Tax Treaties cooking with Malta & Panama

As mentioned in our 10th Tax Alert, a treaty for the avoidance of double taxation was initiated on November 2010 by and between Israel and Malta.

On August 2011, the treaty was signed by both countries, and will enter into force following the formal ratification procedure by both states, assumingly not before 2013. For details regarding the treaty's expected provisions, please refer to Tax Alert no. 10. Furthermore, the Israeli ministry of Finance has announced that a treaty for the avoidance of double taxation was initiated by and between Israel and Panama. According to that announcement, the treaty will limit the withholding tax rate on interest, royalties and dividends paid to a resident of the contracting state by a resident of the other state to 15%. In addition, the new treaty will include an article regarding exchange of information between the tax authorities of both countries.

The treaty will enter into force following the formal signing and ratification procedure by both states, assumingly not before 2013.

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

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