✓Artzi, Hiba & Elmekiesse Tax Solutions Ltd.

Tax News Alert

7 Menahem Begin st., Ramat-Gan 52681, Israel. Phone: 972-3-6134111. Fax: 972-3-6133113
16 Pal Yam Av. Haifa 33095, Israel. Phone: 972-4-9118181. Fax: 972-4-9118188
Web site: www.ahe-tax.co.il E-mail: ahe@ahe-tax.co.il

December 16, 2013
Tax News Alert No. 17

Dear Friends and Clients
We are pleased to update you with selected Israeli tax developments for the last quarter of 2013

Selected Issues:

- Tax consequences upon Distribution from a Trust before the End of 2013
- Far-reaching changes expected in the CFC and FVC rules
- Payment on time of the tax for rental income, is not a condition for the 10% tax rate
- Declaration of residency when purchasing a single residential apartment – who is an Israeli resident, and for which purpose?

Sincerely,
Artzi, Hiba & Elmekiesse - Tax Solutions Ltd.

Tax News Alert No.17 - December 2013

Dear friends,

The Artzi, Hiba & Elmekiesse 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.

Tax consequences upon Distribution from a Trust before the End of 2013

Recently, we receive questions related to the newly enacted legislative changes in the Trust's Taxation Chapter of the Income Tax Ordinance ("**ITO**") regarding the taxation and reporting duties of trusts in which there are Israeli beneficiaries- **is there any advantage to perform distributions from the trust before the end of 2013?**

As already reported, one of the most significant changes in the Trust Chapter in view of the recent legislation, is the cancellation of the favorable tax arrangement for a "Foreign Settlor Trust"- that is, a trust whose settlor is a foreign resident (or who was a foreign resident upon his death), even if it includes Israeli (residents) beneficiaries- and the determination of a more stringent tax arrangement for an "Israeli Beneficiary Trust" (including a "Relatives Trust"), namely a trust of the aforesaid kind, which has one or more Israeli beneficiaries. Such a trust shall be liable to tax, on part or all of its income, insofar as there is an Israeli-resident beneficiary. The timing of the tax liability and the tax rate applicable shall depend on the type of the trust (a Relatives Trust or a "general" Israeli Beneficiary Trust) and the option which has been chosen. **In some of the cases, the reporting duties and tax liabilities apply only at the time of a (taxable) distribution to an Israeli (resident) beneficiary** (in a Relatives Trust, in respect of which the option of taxation at the time of distribution "was chosen").
The Trust Chapter (as per its new version) is effective from the beginning of 2014, so that in all matters pertaining to the actual tax liability in respect of a distribution to a beneficiary, such liability exists (in certain conditions) only from the 2014 tax year and thereafter. One can indeed argue that a

distribution from a Relatives Trust which was performed during 2014 or thereafter- shall be liable to tax even if it derives from profits accrued prior to 2014. According to our position, such a **distribution out of profits accrued up until 2013 is not liable to tax** in this regard. Irrespective of the substantive question pertaining to the tax liability, one of the widespread questions in this regard is **whether the distribution should be reported by the trustee or the beneficiary**, and in this matter, it is necessary to refer to the date of the distribution.

We shall note that in the most recent legislative changes, it was determined that a beneficiary who received a distribution from a trustee (whether the said distribution is liable to tax or not) is required to file an annual report. Up until the said legislative amendment, the reporting obligation applied solely to an Israeli-resident beneficiary and solely in respect of the distribution of a non-money asset (and even then, only a notice of submission was required, and not an annual report).

As far as we know, the position of the Israel Tax Authority ("**ITA**") is that **the obligation to file a report due to a distribution from a trust applies to a beneficiary who has received a distribution as of August 1, 2013**. On the other hand, it may be argued that in view of the legislation's wording such reporting is required only regarding distributions performed after December 31st, 2013. That, since the Trust Chapter (as per its new version) applies to income accrued solely after this date, and after all, a distribution to a beneficiary does not constitute income at all, and *a fortiori*, prior to effective date of the "new" Trust Chapter. We shall note that as long as the reporting forms for the 2013 tax year have not been published, it is not clear what the application is of such reporting duties, or, at least, what the official position is of the ITA in this regard.

There are many trusts which have not been included up until now in the Israeli tax and reporting net, primarily due to their classification as "Foreign Settlor" Trusts. In view of the potential existence of a filing obligation due to a distribution which was made, at the least, after August 1, 2013 (and perhaps even prior to this date) and in view of the expected tax liability in respect of the income which shall be generated commencing from 2014, **it is recommended to examine making an application for an arrangement with the ITA in connection with trusts as described above. It is expected that such an arrangement will also include a "step-up" mechanism for the trust's assets.** An outline of the arrangements for trusts has not yet been published by the ITA, however, we expect that it will be published in the near future.

Our firm has extensive experience regarding trusts and the tax liabilities and reporting obligations applicable thereto.

We would be pleased to be of assistance in the relevant cases.

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

Far-reaching changes expected in the CFC and FVC rules

We wish to bring to your attention some of the expected significant changes in the Israeli tax legislation, concerning two of the main international anti-abuse provisions – Controlled Foreign Companies (CFC) and Foreign Vocation Companies ("FVC"). The **expected** proposed changes are set forth below in summary format (as stated below, those are proposed changes only):

1. **Controlled Foreign Company:**

1.1 Within the proposed changes in the provisions applying to a controlled foreign company (CFC), amendments are proposed, which are intended inter alia to cope with issues to which the Tax Authority has been exposed since the introduction of the CFC regime in 2003. The relevant set of rules states that a controlling shareholder (an individual or a company that is a resident of Israel, holding at least 10% of the controlling interest) in a CFC will be subject to tax for its share in the undistributed profits of the CFC at the end of the tax year as though it had received them as a dividend (deemed dividend). The provisions relate to profits that originate from passive incomes of the CFC, upon which the imposed foreign tax has not exceeded 20%. The proposed changes to the CFC provisions are set below:

1.2 The tax rate threshold to which the CFC provisions will not apply has been decreased from 20% to 15%. In this case, a number of countries in which income is subject hitherto to the CFC rules in Israel, will be excluded from the Israeli CFC regime, including: the Czech Republic (19%), the Netherlands (20% for an income that does not exceed 200,000 euro), Poland (19%), Hungary (19%), Germany (approximately 16%), Great Britain (20% for an income that does exceed 300,000 pounds).

1.3 According to the law currently practiced, the taxable income of the Israeli controlling shareholder is calculated according to the tax laws of the CFC country in the case of a company that resides in a foreign country with which Israel has signed a tax treaty (a "treaty country"), and in other cases, according to the generally accepted accounting principles. Pursuant to the amendment, in the case of a CFC residing in a treaty country, the taxable income will still be calculated according to the tax laws of that country, but the following amounts will be added: (A) dividend or capital gains that have been exempted from tax or that are excluded from the tax base according to the laws of that country (unless if resulting from a re-organization or asset exchange) and (B) specified amounts that have been deducted for tax purposes in that country that are not recognized as

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

an expense or as a deduction according to generally accepted accounting principles (basically deemed expenses). The meaning of the amendment is that a participation exemption regime for example, or deemed interest expenses will no longer decrease the profit based on which the controlling shareholder of the CFC is taxed.

In countries with which Israel has no treaty, the income will be calculated according to the tax laws applying in Israel (and not according to the accounting principles as has been the case heretofore).

1.4 Within the amendment, the provisions for deemed foreign tax credit when taxing a controlling shareholder of a CFC have been cancelled (for example, the tax that would be withheld at source in the country of the CFC when profits distributed as a dividend would no longer be credited from the tax applying to that deemed dividend). Instead of this, at the time of actual dividend distribution, or sale of shares, the tax that was paid in excess may be refunded to the controlling shareholder.

2. **Foreign Vocation Company:**

2.1 In 2003, an anti-abuse provision was enacted, intending to prevent Israeli individuals from avoiding tax in Israel when performing vocation activity (e.g., commissions and management fees) within the framework of a foreign company. This provision prescribes a "source rule", whereby income that a Foreign Vocation Company generated will be considered as an income produced in Israel, even if the business activity or service is actually performed or provided outside of Israel. The part that is subject to tax in Israel pursuant to this provision is limited to the Israeli shareholders' share. Since it was introduced, this regime was controversial, as the tax authorities in Israel asked to apply it to companies residing in treaty countries. Owing to this, the Bill is aiming to change the Foreign Vocation taxation mechanism by taxing the shareholder instead of the company.

2.2 It is proposed that deemed dividend income will be attributed to the shareholder in a Foreign Vocation Company, in accordance with his share in the profits from the special vocation activity (similar to the CFC regime). The tax rate imposed on such deemed dividend will be the corporate tax rate, with a foreign tax credit for the Corporate Income Tax paid by the Company in its residence country.

2.3 The taxation above will be in addition to the dividend taxation applying to the shareholder at the time of distribution of an actual

dividend from the Foreign Vocation Company, according to the ordinary tax rates applying to dividend from a foreign company (25% or 30%), meaning that in the end, the effective taxation of the shareholder of a Foreign Vocation Company will be similar to the taxation of a shareholder in an Israeli company.

Payment on time of the tax for rental income, is not a condition for the 10% tax rate

Pursuant to the Income Tax Ordinance in Israel, rental income is taxable at the regular tax rates (between 30% and 48% on the "net" income). Despite this, an individual who had income from renting a residential apartment may choose to pay tax at the rate of 10%, without the right to deduct expenses (including depreciation) and without the right of offsetting, credit or exemption, if the other conditions of the section are met. Many foreign residents choose this alternative, since by choosing it, they are not required to submit an annual report.

According to the wording of the Ordinance, the tax must be paid within 30 days of the end of the tax year in which the individual had such rental income, and accordingly, the tax authority maintains that the payment of the tax on time constitutes a condition for receiving the benefit. In July 2013, the matter of M.A.C.L. Strictly Kosher Foods Ltd. was received by the Jerusalem District Court. The court ruled that starting from the 2007 tax year, payment of the tax on time does not constitute a condition for the right to choose the 10% tax track, even if it did not pay the tax within 30 days of the end of the tax year. The position of the tax authority in the matter following the above decision is still unclear, and its position may be different.

Declaration of residency when purchasing a single residential apartment - who is an Israeli resident, and for which purpose?

In the framework of the extensive legislative amendments in Real Estate taxation (which we discussed in depth in the previous bulletin), it was decided that, starting from 1 August 2013, the purchase tax rate applying to a “single residential apartment” would apply only to an individual who is an Israeli resident. Recently, the tax authority published a “Declaration of a Purchaser of a Single Residential Apartment” form (no. 7912), which must be attached by a purchaser who is requesting the application of the lower purchase tax for a “single residential apartment” of an Israeli resident.

While the Real Estate Tax Law draws the definition of an “Israeli resident” from Section 1 of the Income Tax Ordinance, the aforementioned form requires additional conditions, which even many Israeli residents do not

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

meet. **In our opinion, the aforementioned form suits a "green track", while in parallel there is a need for a procedure appropriate to Israeli residents, who are also entitled to the purchase tax rate applying to a "single residential apartment" and do not meet the strict requirements fixed in the form.** For example - an individual, who has returned to Israel near the end of the tax year and thus, has stayed less than 183 days in Israel during the same year, but who was already considered to be an Israeli resident when purchasing the apartment.

In addition, the form states that the declaration and purchase tax assessment do not constitute a determination in the matter of the status of the taxpayer's residency, and that this subject will be examined and determined by the income-tax assessor (rather than the Real Estate tax assessor).

In our opinion, it is not appropriate that the two intertwined tax laws, which draw the relevant definition from the same source and are administratively and professionally subject to the same authority, would lead to different tax results under the same criteria for the same taxpayer. The authority should examine the residency of a taxpayer who has submitted this declaration and decide in a manner which would influence all the tax results derived from this determination.

An additional question which arises is the applicability of the provisions of the Double Tax Treaties in this context: **will an individual who is considered to be an Israeli resident under the provisions of the Ordinance be considered an Israeli resident in the matter of Real Estate taxation, even if he is considered a foreign resident under the provisions of the Traety?** According to the approach of the tax authority in similar matters, a "returning resident" is entitled to relief from the moment he returns only if the Israeli residency was ceased according to the provisions of the Ordinance, and it is not sufficient that he was considered a foreign resident during those years under the provisions of the Treaty only. **In our opinion, we can conclude from this that an Israeli resident under domestic law (i.e., the Ordinance) is entitled to purchase tax relief even if he is a foreign resident under the Treaty.**

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

CPA Ran Artzi, Managing Partner (artzi@ahe-tax.co.il)
Advocate and CPA Hagi Elmekiesse (hagi@ahe-tax.co.il)
Advocate and CPA Gadi Alimi (alimi@ahe-tax.co.il)
CPA (LLB) Eyal Sando (sando@ahe-tax.co.il)