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April 13, 2014

Tax News Alert No. 18

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

### Selected Issues:

- Update on Legislation Regarding a Controlled Foreign Company ("CFC") and a Foreign Vocation Company ("FVC")
- Updates Related to Taxation of Trusts
- Yanco-Weiss Case – the "Management & Control" Criterion
- Tax Treaty with Malta Enters into Force
- The "Belt" Around Israelis Possessing Properties Overseas is Tightening

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

## Tax News Alert No.18 - April 2014

*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.

### ***Update on Legislation Regarding a Controlled Foreign Company ("CFC") and a Foreign Vocation Company ("FVC")***

In our newsletter from December 16, 2013 (No. 17), we elaborated on the expected legislative changes from January 1, 2014 on the subject of a CFC a FVC. The main changes are as follows:

- The corporate tax rate in the foreign country that constitutes a criterion for the determination of a CFC has been reduced from 20% to 15%;
- A change in the manner of measuring the taxable income, so that under the CFC regime exempt capital gains and exempt dividends will also be included, such as income treated under the regime of the participation exemption, and expenses which are not included in the financial statements (deemed expenses) will not be taken into account.

- The deemed credit system for the taxation of the deemed dividend has been cancelled.

- A change in the taxation system regarding to a FVC to the effect that the taxpayer for the FVC's income will be the controlling shareholder and not the company itself, like in the CFC regime ,with certain adjustments that relate to the tax rates and the two-stage taxation method.

We would like to update that the aforesaid legislation has been finally accepted and came into force from January 1, 2014.

## Updates Related to Taxation of Trusts

### 1. Transitional arrangements for trusts that have been established by foreign residents:

Recently, the Tax Authority has published transitional arrangements that establish different tax tracks for trusts that have been created by foreign residents, in which there is an Israeli beneficiary, in certain cases. These arrangements are intended to cover trusts in the Israeli tax net that through to December 31, 2013 were not liable to tax or were claimed to be as such, and that from January 1, 2014, in view of the new legislation, are liable to tax in Israel.

The arrangements allow for those who choose to do so, subject to the tax payment in one of the two tracks that have been established, to resolve for tax purposes the trust capital and the trust's taxable income for the relevant years, with an option to reevaluate the trust's assets according to their value at that time (a "Step Up" settlement), thus resolving potential disputes and exposures concerning the issue of the trust's classification for the previous years and its tax liability, if any, accordingly.

This possibility, that is currently given to trustees in such trusts, is to be associated with the duty of beneficiaries who are Israeli residents to submit a tax return for

the 2013 tax year, if they have received a distribution from a trust in that year, and particularly from August 1, 2013, and state in that tax return (whether submitted for that reason or for another reason) the distribution amount that they have received. Such reports may of course lead to the knowledge of the existence of those trusts and also arouse the curiosity of the Israeli Tax Authority ("ITA") in all matters relating to their classification and their positional tax aspects. **The transitional arrangements may be conducted on an anonymous basis.**

Further details on the applicable tax rates and the various tracks may be found in our previous report on the subject dated from March 11, 2014.

### 2. Postponement of required notices' submission dates and publication of forms;

Recently, the ITA announced on the postponement of dates for submitting certain notices that have been established under the recent legislation regarding trusts - within the scope of Amendment No. 197 of the Israeli tax Ordinance ("ITO"), and the relevant forms have been published. In addition to the existing forms, two new notices and appropriate forms have been added:

- A notice of an "Underlying Company"- according to the wording of the legislation, the

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submission date (within 90 days of the date of incorporation!) constitutes a condition for the classification of such a company, and it would seem that a delay in the notice's submission may deny the aforesaid classification, which may have severe consequences. Regarding trusts that were created prior to August 1, 2013, a notice will be submitted on the date of filing the tax return for the 2013 tax year.

- A notice of selection of a taxation track in a "Relatives Trust"- one of the tracks for this kind of trust (as chosen by the trustee) is the annual taxation track, in which tax at a rate of 25% is imposed on the annual taxable income of the trustee, even if it has not yet been distributed to a beneficiary. Such a notice should be submitted within 60 days of the day of creating the trust (or from the day on which it becomes a Relatives Trust) and with respect to existing trusts, a notice is to be submitted by June 30, 2014. If the annual taxation track is not chosen, the beneficiary who is a resident of Israel will be liable to tax upon the distributions that he would have received at a rate of 30%.

3. Beneficiary's reporting obligation concerning distributions from a trust

in the 2013 tax year

The last legislative change on the subject also included the duty of a beneficiary who received a distribution from a trust to file a tax return in Israel. This notice provision is valid, according to the wording of the ITA, from August 1, 2013, and some may argue that such a duty applies only from the 2014 tax year. To the best of our knowledge, there are trustees who have made distributions from foreign trusts to beneficiaries who are Israeli residents before the new legislation came into force, i.e. before August 1, 2013. This is under the assumption that the provisions of the new legislation concerning the reporting of distributions will not apply to distributions before this date.

The 2013 tax return form that has been recently published requires an individual, first to indicate whether he is a beneficiary of a trust from which he has received distributions throughout the 2013 tax year!!! In addition, in another field in the tax form, the individual is required to indicate what the distribution amount is. This is informative data only, because distributions in 2013 are not taxable income by the hands of a beneficiary and in general (a tax liability may arise only from 2014 in a certain case).

In our opinion, despite the existence of such notification duty as set forth

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within the form that has been published, the receipt of a distribution in money (to an unlimited amount) before August 1, 2013, in and of itself, does not impose an obligation on an individual to file an annual tax return. However, individuals who must file tax returns to the assessment office for the 2013 tax year in any case, for any reason, are required to report, according to the ITA, the distributions that they have received throughout the year.

4. The obligation of a foreign trustee to submit documents to the assessment office in Israel

Recently, a verdict has been published in the District Court in Tel Aviv (the "Steinmetz" case) concerning the obligation of a foreign trustee in a foreign trust to provide statements and documents. In that case it was ruled that although the trust was created under

a foreign governing law (that is not Israeli), and although the trustee in that trust is not an Israeli resident, there is an obligation to provide reports and documents that have been required by the assessing officer, or alternative documents, if there are any (in case that the requested document are not existing).

We should point out that the judge's ruling does not constitute a wide rule that applies to all cases in which foreign trusts are involved, but was given in the circumstances of the specific case. However, the general trend of the Court and the attitude of the Court concerning the lack of cooperation between the trustee and the tax authorities may be understood and learned from this ruling, particularly when the creator of the trust and possibly the beneficiary are Israeli residents.

**Yanco-Weiss Case - the "Management & Control" Criterion**

A few weeks ago, a verdict was handed down in the District Court in the matter of Yanco-Weiss Holdings (Tax Petition 1090-06) on the subject of the "Management & Control" criterion as a parameter for determination of the residency of a company. A similar verdict (the "Niago" case) was handed down about two years ago. It appears that the trend whereby the legal means for attacking (aggressive) tax planning

that relies on an argument of foreign residency of a company, through a factual determination whereby the "Management & Control" of the business affairs is conducted in Israel, is continuing. Like the "Niago" case, here too, the extreme circumstances of the case of tax avoidance led the way to the inevitable ruling of the Court.

This was a case of an Israeli company with an activity in Israel and holdings in

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Israeli companies, when prior to the sale of one of its subsidiaries, the company made moves to change its residency for tax purposes, including its registration at the Company's Registrar in Belgium, and also started to establish activity of acquisition of real estate properties there. The argument of the company was that at the time of the sale of the shares, it was a resident of Belgium for tax purposes and is therefore exempt from tax according to the provisions of the tax treaty between Israel and Belgium.

It shall be noted that from 2003, an "Exit Tax" was imposed in the ITO, so that in a similar case, if it were to apply today, it will be argued that as a result of the exit tax, there is no exemption from tax in the sale of shares (at least not a full exemption).

Examining the circumstances of the specific case revealed that the management personnel in Belgium was

not significantly strong, authoritative and involved in the details of the financial activity of the company. According to the judge, today's technology reasonably facilitates the management of a company by "remote control", meaning that the level that is required for proving the opposite is more difficult. However, it was stated that the management by Israeli shareholders or managers could be done from outside of Israel, or in part in Israel too, as long as the main part of the management apparatus is located overseas.

In any case, on this matter, in view of the exceptional circumstances of the case, in Mutual Agreement Procedures that were conducted between the two states, the Belgian competent Authority consented to recognize that it was an Israeli resident company pursuant to the rule of effective place of management.

### **Tax Treaty with Malta Enters into Force**

The Income and Capital Tax Treaty between Israel and Malta ("the Treaty") has been ratified in Israel (after its ratification in Malta) and took effect on January 1, 2014.

The Treaty sets the withholding tax rates according to the passive type of income below, subject to the fulfillment of conditions and exclusions that have been prescribed in the relevant sections in the Treaty:

Dividend - the Treaty differentiates between a recipient that is a resident of Israel and one that is a resident of Malta:

A. With respect to a resident of Malta, receiving a dividend from an Israeli company, maximum withholding tax at the rate of 15% will be deducted. If the recipient is a Maltese company, holding at least 10% of the share capital of the company distributing the

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- dividend, no withholding tax will apply.
- B. With respect to a resident of Israel receiving a dividend from a Maltese company, the Treaty prescribes withholding tax at a limited rate. We shall point out that according to the Maltese tax law, tax is not withheld at source when distributing a dividend to a foreign resident.
- Interest - the Treaty prescribes withholding tax in the source country at a maximum rate of 5%. We shall point out that according to the Maltese tax law, tax is not withheld when paying interest to a foreign resident.
- Royalties - the Treaty grants an exclusive taxation right to the country of residency. We shall point out that in this case too, the Maltese tax law grants a full exemption from withholding tax.
- The Treaty includes an extensive clause for the exchange of information between the two tax authorities and a "limitation of benefits" clause for prevention of abuse.
- In addition, the term "person" also includes a trust. In the case of a trust being classified as a resident of both countries, the competent authorities will try to agreed on its residency by mutual agreement; for this purpose, major criteria for determining the place of residency of a trust for a certain period are brought up, such as the place of residency of the trustee, the settlor or the beneficiaries, the place of the assets of the trust or the law regulating the operation of the trust. In the absence of agreement, as a rule, the provisions of the Treaty will not apply to the trust.

### ***The "Belt" Around Israelis Possessing Properties Overseas is Tightening***

The State of Israel has signed more than 50 tax treaties with other countries, within which there is usually a clause dealing with exchanges of information, to the extent that the information is required for executing the provisions of the treaty or application of internal law dealing with taxes that are covered by the treaty.

Besides exchange of information within information exchange clauses in tax treaties, there are additional arrangements that have been formed in recent years that deal with exchanges of information on tax issues - the Convention on Mutual Administrative Assistance in Tax Matters, which Israel has not signed for the time being. In addition, in recent years, tax information exchange agreements - TIEAs have been signed on tax affairs, including with countries that are considered to be tax havens.

Israel has declared its intention of signing information exchange agreements with other countries with the intent of

gathering information on income and assets of Israelis overseas, in view of the increasing trend in Israel and in the world to combat tax evasion. Information that is gathered by the ITA is subject to a duty of confidentiality, and may be disclosed only to a country that has signed a tax treaty with Israel. In order to be prepared for the possibility of providing information to countries that have not signed a tax treaty with Israel (for example, information exchange treaties, or the FATCA Agreement, if signed), a bill has been introduced that will enable the disclosure of information in such circumstances, and conditions have been prescribed for such transfer of information, including the necessity of the information for the foreign country for the purpose of enforcement of its own tax laws, safeguarding information security and limited use of the information.

These expected steps are being taken alongside the formation of a **new procedure for voluntary disclosure** that is about to be published, being intended for taxpayers that are interested in initiating a procedure of voluntary disclosure of their income and assets that have not been reported and the payment of the taxes, whereby the applicant will probably be given an **option for conducting an anonymous procedure to resolve his tax liability.**

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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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