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Tax News Alert

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Dear Friends and Clients
We are pleased to update you with selected Israeli tax developments for the third quarter of 2014

Selected Issues:

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

Tax News Alert No.19 - September 2014

Dear friends,

We take this opportunity to send our wishes to you all, on the occasion of the ROSH HASHANA & YUM KIPPUR: We wish you a year of Joy, Love, Health and Bless. May you be inscribed (in the Book of Life) for Good.

The Artzi, Hiba, Elmekiesse, Cohen - 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.

Voluntary Disclosure Procedure and Temporary Order for Anonymous Applications

On September 7, 2014, the Israel Tax Authority ("ITA") published a new "**Voluntary Disclosure Procedure**" (hereinafter: the "**Regular Procedure**") which is intended to replace the current voluntary disclosure procedure that was published in 2005. The Regular Procedure is effective from the date of publication thereof and up until December 31, 2016. Concurrently, and at the same time, a temporary order was published which is in effect from the date of its publication for one year up until September 6, 2015 (hereinafter: the "**Temporary Order**") and which is based on the provisions of the Regular Procedure, but which allows special tracks (an anonymous track and an expedited track). Below are details of the main terms, conditions and possibilities set forth in the Regular Procedure and in the Temporary Order.

The Regular Procedure

The Regular Procedure relates to all tax offenses and not necessarily in connection with reporting of assets and income located abroad, including offenses in connection with real estate taxation, income and corporate taxation, VAT, purchase tax and customs.

The threshold conditions for being included in the Regular Procedure are similar, for the most part, to the conditions stipulated in 2005. Thus, for example, the application must be honest and it must be made in good faith, and the application must not be made at the same time as an investigation or examination by the ITA in the same matter and in respect of which, on the date of the application, the ITA has no prior information. Having said that, there are a number of new conditions set forth in the Regular Procedure, two of which are specify below:

- The new Regular Procedure grants an additional concession in the form of the undertaking that in the event of the rejection of the application, **the ITA will not make use of the information which was provided in the application, neither in a criminal proceeding nor in a civil proceeding.**

- An additional restriction which has been determined is that **an application will not be approved if it does not include a significant tax payment**, except in cases such as inheritances which are received and which do not generate significant tax, with the exception of the tax on the yields. In addition to the lack of clarity, this restriction is problematic because criminal immunity should not be dependent on the amount of the tax due. Furthermore, this restriction contains a kind of discrimination between the holders of extensive wealth which is not reported and the holders of small accounts.

The Temporary Order

The Temporary Order is based on the provisions of the main Regular Procedure so that compliance is required with the terms and conditions set forth therein (see above). Nevertheless, the Temporary Order contains additional possibilities which are not included in the main Regular Procedure:

- The Anonymous Track: in this track, it is possible to make an application without giving names or identifying details, up until the completion of the assessment proceeding, as was the case in the temporary order published about two years ago. Nevertheless, a period of time of 90 days has been determined (with the possibility of the extension of this period for an additional 90 days by the Tax Assessor), for completion of the assessment proceeding. Already at this point in time, the ITA should give its opinion regarding this time restriction given that, in all likelihood, it will not be possible to comply with it in all eventualities, due to various constraints, including of ITA itself.

- The Expedited Track: the expedited track is suitable for a taxpayer whose reported capital pursuant to the disclosure is up to NIS 2 million, and whose total taxable income is up to NIS 0.5 million. According to this track, **which is not anonymous**, the taxpayer declares and pays the tax together with the filing of the application (as part of the filing of tax reports). As far as we are concerned, this track is shrouded in obscurity, and it does not provide the certainty which the ITA apparently sought to provide. It is not even certain that the taxpayer's position regarding his taxable income and the applicable tax will be identical to the Tax Assessor's position, and this proceeding does not determine finality for the income and for the tax being reported and paid by the applicant, among other things, due to various claims of the ITA regarding the taxation of the source of the funds and many disputes are likely to arise in this regard.

Ostensibly, it is up to the applicant to choose which of the track he prefers, and in this regard, **it would appear that in cases where there is a concern of disputes as stated above, then it would be advisable to examine the submission of an application in the anonymous track, rather than an application in the expedited track.** The Temporary Order states that the Tax Assessor may, at his own initiative, refer the taxpayer to this track.

A Trust Which Has Been Set up, but Assets Have Not yet Been Transferred Thereto, Is Not Subject to Reporting in Israel

The Trusts' chapter in the Income Tax Ordinance ("ITO") requires the reporting of trusts and the opening of files with the Tax Assessor's office in the appropriate cases. There is no doubt that these obligations apply to a trust in which the settlor is an Israeli resident (in which case, the trust will generally be deemed to be an "Israeli Resident Trust").

The question arises as to whether the establishment of a "shelf trust" requires reporting and opening of a file with the ITA. For example, if a person has engaged with a trustee for the purpose of creating a trust so that the trust will be prepared to receive assets in the future, upon the satisfaction of certain external conditions, and that a trust deed has even been prepared and signed. The assets that will be transferred in the future to the trust shall constitute the "trust assets", and they shall be subject to the provisions in the trust deed.

We shall note that the said external condition is beyond the trustee's control, and we are not discussing the case where the trustee has an option to purchase the assets.

Our position is that the reporting obligation to the ITA will arise only in the future – at the time of the occurrence of the event in the course of which assets will actually be transferred to the trustee. This position is based on the definition of a "trust" in section 75C of the ITO, which determines that:

"'Trust' - an arrangement under which a trustee holds the trustee's assets for the benefit of the beneficiary….."

As we can see, section 75 of the ITO determines that in order for a "trust" to be created as defined in the ITO, there must be an arrangement (namely, the trust deed between the settlor and the trustee) and also, the trustee shall be "the holder of the asset". In the absence of an asset – then the "trust" has no existence, and the result of the foregoing is that there is no relevance to the reporting obligations to the ITA.

Even if we put it more precisely and say that the ITA may claim that the arrangement according to which the trustee is likely to hold an asset in the future is sufficient for reporting on the trust - then, we are faced with a legislative item which lends itself to two linguistic interpretations, and this being the case, we shall refer to the purpose of the legislation.

There is no doubt that the purpose of the trust legislation was not to report and to open a file for a "trust", when we are dealing with an agreement only, without any assets or income whatsoever. To complete the picture, as long as the asset has not been transferred to be held by the trustee, then the current owner of the asset reports both the asset and the income generated therefrom.

We shall note that this interpretation will apply in the case which we were referring to – a situation in which there is no asset held by the trustee. The right to receive an asset (such as an option) is considered to be an asset in and of itself, and therefore, it will be subject to reporting.

Our firm deals extensively with the subject of the taxation of trusts and tax arrangements for existing trusts. In view of the complexity of the provisions in the field of trust taxation, we recommend to examine the facts and consequences prior to taking any action.

The Tax Treaty between Israel and Panama Has Entered into Force, and a New Tax Treaty Has Been Signed with Germany

Below we shall review, in brief, the provisions of the tax treaty with Panama, which will enter into force from the 2015 tax year, and the new tax treaty which has been signed (but not yet ratified) with Germany.

The Tax Convention with Panama

As is well known, the tax system in Panama is primarily territorial, both with regard to individuals and also with regard to companies. In principle, the treaty is based on the OECD Model Convention, and the main provisions of the convention are as set forth below:

1. Residency – the first tie-breaker test with regard to individuals is the test of the permanent home (similar to the OECD Model Convention). With regard to an entity, which is not an individual (including a company and a trust), attempts should be made to determine the issue of double residency by proceedings of mutual agreement based on the place of effective management.

   The residency section and the protocol to the convention include specific reference to trusts. In the protocol, it is determined that in their attempt to determine the domicile of a trust for a certain period of time, the competent authorities will take into account all of the relevant factors (the trust law, the location of the trust's assets and the residency of the relevant individuals in the trust).

2. The withholding tax applied to dividends is, as a rule, at the rate of 15%. In addition, the imposition of branch tax up to the rate of 5% is permitted. We shall note that according to the domestic law in Panama, a branch tax at the rate of 10% is levied on permanent establishments, whereas Israel currently does not levy branch tax.

3. The withholding tax applied to interest and royalties is, as a rule, at the rate of 15%.

4. Capital gains from the sale of shares: the first taxation right is reserved for the country of source in cases of ownership of over 50% of the company being sold (in such a case, the tax is limited to a rate of up to 5%); in other cases, as a rule, the taxation right is reserved only to the country of the shareholder's residency. We shall note that with respect to capital gains which have accrued for a resident of Panama from the sale of shares of an Israeli

company, the provisions of section 97(B3) of the ITO prevail, which grant a full exemption (also in case of holding more than 50% in an Israeli resident company), provided that the terms and conditions of the section have been fulfilled.

5. With regard to other income (which is not discussed in other sections of the Convention), an exclusive taxation right is granted to the country of residence, provided that the entity producing the income is subject to tax on it in the said country.

The Effect of the Convention with Panama on the Provisions Which Exist in the Israeli Law:

1. The Convention includes an 'Exchange of Information' section, as exists in other conventions. It follows that the State of Israel will be able to receive information which exists in connection with Panamanian companies (and *vice versa*). We shall note that according to the Convention, information may be requested retroactively in relation to a period of three years prior to the date of the Convention entered into force, that is to say – from the beginning of 2012. Beyond the foregoing date, we shall note that in recent years, the subject of exchange of information has been a dynamic issue, and the rules of information exchanges are due to change in the coming years, among other reasons, in view of the "Multilateral Convention on Mutual Administrative Assistance in Tax Matters", which Israel is likely to join in the near future.

2. Shareholders who hold or purchase shares of Panamanian companies at a rate of 25% or more will not be required to file Form No. 1213, regarding tax planning subject to reporting.

3. The calculation of the taxable income of a Panamanian company, pursuant to the implementation of the provisions of the ITO with regard to CFC or with regard to a Vocation Company, will be based on the tax laws in Panama, and not on the provisions of the ITO, as have been in effect until the present day, and subject to the exclusions set forth in the ITO.

The New Convention Signed with Germany

In August 2014, a new convention was signed with Germany, which replaces the previous convention which was signed in the 1960s. The convention has not yet been ratified by the parties,

and in the event that it is ratified before the end of 2014, then its provisions will enter into force from January 1, 2015. The new convention is based on the OECD Model Convention. Below are the significant changes which have been introduced into the new convention as compared with the current convention:

1. Dividend and Distribution from a Real Estate Investment Company

   The withholding tax applied to dividends has been reduced from a rate of 25% to 10%, and in case of holding at least 10% in the company paying the dividend – 5%. In addition, the provisions of the Convention make reference to a Real Estate Investment Funds, so that a withholding tax applied to distributions from such funds (as defined in the ITO or in the German law), at a rate of 15%, provided that the investor holds less than 10% of the fund.

2. Cancellation of the Indirect Credit Mechanism:

   The indirect tax credit for individuals and for companies, which exists in the current convention, **has been cancelled**, which means that when the new convention will enter into force, the narrower provisions of the ITO will apply (according to which the indirect credit will be granted only to companies, provided that there is a holding of 25% or more). **Consequently, the stated below shall apply with regard to a person who possesses the ability to control the timing of the dividends distribution: with regard to an individual who is a significant shareholder (who holds 10% or more) in a German-resident company, it is recommended to precede the dividends distribution so that he will only pay 25% tax on the dividend in Germany (without being required to pay the supplemental tax in Israel, following the indirect credit mechanism in the current convention) instead of 30% in the following year (in the absence of the indirect crediting). With regard to an Israeli company (which holds 25% or more), on the other hand, it is recommended to consider delaying the dividends distribution, because indirect credit does exist in respect thereof according to the domestic law, and therefore, the relevant consideration is the reduction of the withholding tax from the rate of 25% to 5%.** In this manner, in total, (including the German corporate tax which applies

to the distributing company) 26.5% will be paid by it in respect of passive activities (instead of 37% at the present time) and approximately 34% will be paid by it in respect of business activities (instead of approximately 48% at the present time).

3. Interest

The withholding tax levied on interest has been reduced from a rate of 15% to 5%. According to the domestic law in Germany, there is no withholding tax levied on interest payments, except in exceptional cases (such as a profit-sharing loan, see below). In accordance with the protocol to the new convention, the reduced withholding tax rate will not apply to profit-sharing loans and similar instruments (as set forth in the protocol), which are deductible at the German company paying the interest, but rather, the German law will apply thereto. in other words, the withholding tax will be at the rate of 26.38%. **We shall note that even after the new convention will enter into force, in the appropriate cases and subject to the rules of transfer prices, it is advisable to consider the option of interest-bearing financing, inspite of the withholding tax rate, instead of the withdrawal of profits as a dividend.**

4. Royalties

According to the new convention, income from royalties will be taxed only in the country of domicile of the recipient of the payment, as compared with a withholding tax at the rate of 5% which is stated in the current convention.

5. A "trust" is included in the definition of the term "person", without giving additional details in the convention or in the protocol, and a trust may benefit from the benefits of the convention (as is the case in a number of new conventions). In the current convention, there is a doubt with regard to the trust's eligibility per se to the benefits of the convention, and in many cases, double taxation may arise because the taxpayer in one contracting state is not the taxpayer in the other contracting state (for example, in one contracting state, the settlor is taxed at the time when the income is derived by the trust, and in the other contracting state, the beneficiary is taxed upon receiving distribution from the trust's income).

The "Big Brother" Effect – the Israel Tax Authority is Requesting Details from Tens of Thousands of Residents

Recently, more than 100,000 citizens of Israel, most of whom do not submit annually tax returns to the ITA, have received a demand to submit certain details to the "Identification" Department of the ITA, for the purpose of the conducting of a preliminary examination.

The demand is for the citizen to fill Form No. 5329, whose heading is "**Report of Personal information and Declaration of Sources of Income in Israel and Overseas**".. We shall note that based on this form, and in the discretion of the ITA, an assessment file may be opened for the relevant taxpayer.

From the cases which have been brought to our attention, it is possible to catalog the population who have received the demands as including, primarily, citizens with a large number of entries and departures into and out from Israel, and also citizens who own a number of real estate assets.

On the form, the citizen is required to provide details, among other things, as to whether he is a shareholder of any company whatsoever, whether he is a an employee (including of a foreign company), concise details of all of the real-estate assets and vehicles which he owns, details regarding his income and details regarding bank accounts which he holds. With respect to someone who is a new immigrant and/or a old returning resident, the demand is solely with regard to assets and income in Israel.

The purpose of the demand, among other things, is to identify cases of assets owned by Israeli residents and/or income overseas derived by Israeli residents, which are not being reported in accordance with the ITO.

Many of the people who have received the demands are Israeli residents who own a number of residential apartments which have been rented, and in respect of these apartments, a number of common questions are asked with regard to reporting duties and taxation of rental income. **We wish to emphasize that the tax liability in respect of the rental income in Israel also applies to foreign residents who own apartments for rental in Israel.** Please find below a number of the questions which were referred to our office, for example:

1. <u>Is there an exemption on rental income from residential properties in Israel?</u>

   The maximum exemption on rental of a residential apartment has been significantly reduced in the last decade, but on the other hand, the rental income on the said apartments has risen dramatically during the same period.

The monthly maximum exemption in 2004 equated to an amount of NIS 7,390, whilst in 2013, the maximum equates to only an amount of NIS 4,980. We wish to note that the exemption mechanism is dynamic, and the maximum exemption is reduced as the rental income is increased.

2. Is all rental income in Israel entitled to tax at a rate of 10%?

   The ITO allows a track of 10% tax on the "turnover" from the rental income, without any offsetting expenses or exemptions. In contrast to the past, effective from 2007, the tax track of 10% on residential rental income is not contingent upon an advance payment to the ITA. This track is not "opened" for rental income until 2006.

3. Can depreciation or interest on a mortgage be deducted (and if so, at what rate)?

   Expenses cannot be claimed in the 10% track (including depreciation and interest), but can only be deducted in the other tracks.

   In the regular track, as a rule, the "regular" depreciation regulations allow depreciation at the rate of 4% out of an amount of two thirds (2/3) of the cost of the real-estate (one third (1/3) is attributed to the real estate's land component). In this track, it is also possible to claim, as stated above, additional expenses, such as interest on a mortgage and also, various maintenance expenses.

4. Should one apply to voluntary disclosure procedure to formalize non-reported income from rent?

   Given the fact that, when it comes to issues such as these, there is a chance that criminal proceedings may also arise, it is necessary to conduct a thorough examination of the way in which the proceeding is conducted with the ITA, including an examination of the option to submit an application pursuant to the voluntary disclosure proceeding, which is intended, among other things, to remove the criminal sanctions (see the above report on the new proceeding which has been published). As an example in this matter, we shall note that in one of the decisions of the "Forfeit Committee" at the ITA (the forfeit proceeding is a criminal proceeding in the course of which the taxpayer pays a "forfeit" to the ITA instead of being prosecuted), a penalty was paid of NIS 150,000 due to the non-reporting of rental income in an amount of NIS 500,000, irrespective of the tax which the taxpayer was required to pay.

Recently, the ITA has conveyed a message to the citizens of Israel and to the Tax Assessors, that there will be tolerance and flexibility regarding those taxpayers who approach the ITA to settle their unreported income, and it has implied that it will be satisfied when having reports from 2007 (at least in relation to those taxpayers who are not required, in principle, to file reports, but rather, only to pay the tax in the 10% track), without taking criminal proceedings, except in exceptional cases. Having said that, due to the inherent risks in the matter, and as we have already stated above, all are recommended to seek professional advice prior to making an application to the ITA and prior to giving any answers or submitting any documents to the ITA.

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

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