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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 last quarter of 2014

Selected Issues:

- Extension for the Submission of Applications for Trust Arrangements
- The eligibility of a Family Company to enjoy treaty benefits
- The diminishing effect of the subjective test when examining tax residence
- The Israel Tax Authority is conducting investigation and taking measures against undisclosed foreign bank account holders
- Tax credit in Israel for branch profits taxes that were paid abroad
- Reporting duties by the trustee and by the settlor upon the immigration of the settlor to Israel

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

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Dear friends,

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.

Extension for the Submission of Applications for Trust Arrangements

Further to our special tax alert dated March 11, 2014 on the subject of “Israel Taxation of Trusts - Transitional Arrangements Published by ITA”, we wish to bring to your attention that the Israeli Tax Authority (hereinafter: "ITA") has decided to grant an extension till June 30th, 2015 (instead of through to December 31st, 2014) for resolving a trust that is classified as an “Israeli Resident beneficiary trust”.

These are primarily trusts that were created by foreign residents before December 31st, 2013, in which there is an Israeli beneficiary, and this kind of trust became an Israeli taxpayer from the 2014 tax year.

Our office has been accompanying a large number of trusts and their tax regularization with the ITA, including concerning the above mentioned arrangement.

The eligibility of a Family Company to enjoy treaty benefits

An Israeli individual may invest in assets and hold them overseas directly or alternatively through an Israeli company. In Israel, an individual may apply to classify the Israeli company as a family company. The tax regime relating to such a company is that its taxable incomes will be allocated to one shareholder only (usually the shareholder holding the majority of the shares in the family company).

The family company will apply to enjoy benefits pursuant to a tax treaty that applies to a company that is a resident of Israel. In Israel's new tax treaties, which are based on the wording of the OECD treaty model, such as, for example, the new tax treaty with Germany's (not yet ratified), a company is defined as "**any body corporate or any entity that is treated as a body corporate for tax purposes**". Therefore, it would seem that the family company is entitled to enjoy a reduced tax rate that applies at the time of receipt of a dividend from a company that is a resident of Germany, at a rate of 5% (in the case of dividend from a company that is a resident of Germany and is held by the an Israeli resident company at a rate of at least 10%), instead of a tax rate of 10%, which applies to an individual who is an Israeli resident.

Can the German tax authority argue that despite being a corporation for tax purposes, the family company is not the beneficial owner of the income, but rather its shareholder who is taxed on the incomes of the company, in which case the German tax authority will request to apply a tax rate of a rate of 10%? There may also be an argument on the part of the foreign tax authority that in our view is extreme, that according to the definition of a "resident", the family company is not considered to be a "**resident of Israel**" for the purposes of the treaty and therefor its provisions are not applicable, meaning that the withholding will be according to the provisions of the domestic law in Germany, at a rate of 26.38%. In our opinion, there is no place for such argument, particularly when the entity is transparent and the holders of its rights are residents of the same country.

This issue may arise in the context of the application of additional treaties with foreign companies, in which there is a difference in the withholding tax rates between an individual and a company, and in the domestic law in that country.

In the aforesaid cases, would the ITA permit an individual claim tax credit in

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Israel for the surplus tax that was withheld from him in that foreign company? **If the ITA would allow to credit only the tax that was supposed to be withheld from an Israeli company in accordance with the provisions of the treaty, in this case, in our view, the competent authority in Israel would be required to engage in mutual agreement proceedings with the equivalent foreign authority in order to resolve the double taxation.**

In a similar context, the ITA has published Taxation Decision (No. 4554/12) in which it stated, for the purposes of investment in the USA through a family company, that the tax credit that would be given to an individual in Israel would be the lower out of the following alternatives: (1) the foreign tax that was actually paid in the USA by the family company; or (2) the foreign tax that would have been paid in the USA by the taxpayer if he had held the LLC directly rather than through the family company.

In our opinion, there is no room for such a restriction: once the provisions of Israeli law allow the shareholder in a family company to be the taxpayer with respect to incomes of the company, the foreign tax that was paid by the company has to be attributed to him and given as tax credit against the Israeli tax applying to him.

The diminishing effect of the subjective test when examining tax residence

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In October 2014, the District Court in Haifa gave a ruling for the case involving Mrs. Yael Tzur (hereinafter: **"the Appellant"**), an employee of ZIM Integrated Shipping Services Ltd (**"Zim"**), which dealt with the question of severance of Israeli residency for tax purposes and the date thereof. The ruling constitutes, in our opinion, a continuation of a certain trend that is reflected in case law, inter alia concerning splitting the family unit residency, whereby in the current global village in which changes in the domicile of individuals and families have become routine, the question of severance of residency must be examined in a more liberal manner.

The details of the case in a nutshell: the Appellant was an employee at Zim, who left the company and started to work at ZIM's subsidiary in Hong Kong (hereinafter: **"the Foreign Company"**) from the end of 2005, and in January 2006, the Appellant's family joined her. In the period in which they were abroad, the objective indicators for establishing a tax residency in Hong

Kong were fulfilled, including staying in Israel for a low number of days, the existence of a permanent home abroad (rental), the absence of such in Israel (their dwelling in Israel was rented out), enrollment of the children at education institutes in Hong Kong, maintaining a social and community life outside of Israel etc.

In practice, despite the Appellant was expecting to stay in her position at the Foreign Company for several years, her employment was terminated after about two and a half years, after which she returned with her family to Israel.

In the ruling it was stated that the Appellant (and most probably her family too) had severed her Israeli residency immediately after her departure from Israel, and according to the court: "***There may be cases in which the change*** (of residency - A.H.E.C) ***is clear and unequivocal. In the current case the change is clear***". It should be emphasized that this ruling constitute the implementation of the provisions of domestic tax law in Israel and not the implementation of a tax treaty provisions for determining residency (which does not exist between Israel and Hong Kong). Besides the final conclusion of the court, the ruling raises other interesting matters, as:

- The fact that the employer (Zim) chose to continue to withhold tax from the wages of the Appellant as a resident of Israel does not affect the professional decision on the question of her residency.

- The decision that foreign residency for a relatively brief period may occur, is based on objective indicators in that period and less on the subjective tendency or intent of the Appellant. As a rule, it would appear that over the time, less significance is attributed to the subjective test, in examining the question of residency. In addition it has been determined that a tax payer may leave Israel for a set period of time that is known in advance, during which he will be considered as a foreign resident, on the condition that he substantiates the criteria of the tax residency test during that period. We must state that this ruling contravenes the position of the ITA as expressed in the ITA circular presenting a summary of decisions on the subject of residency, in which, in a case of relocation for a period exceeding 3 years, residency is severed, for the purposes of a tax treaty only, after half a year of leaving Israel, and in the case of a period of less than 3 years,

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residency is not severed at all, even for the purposes of a tax treaty.

- It has been determined that the burden of proof, when the numerical presumption of a accumulated period of stay in Israel (425 cumulative days in three years) is fulfilled, is inferior to the burden that is required upon the fulfillment of the numerical presumption of 183 days in Israel per tax year, primarily because the overall presumption is more appropriate for examining the residency of a person who habitually divides his time between two or more countries, and is less suitable for one who has performed a relocation (in which case the period prior to his leaving is not supposed to affect the question of residency).

A question that is left unanswered is whether in the case of relocation for a period that is known in advance to be two and a half years, would it still be determined that the residency is severed from the first day? or possibility is that the initial intent of a long stay and the termination thereof that was not at the initiative of the Appellant is what affected the decision of the court.

The Israel Tax Authority is conducting investigation and taking measures against undisclosed foreign bank account holders

Recently, the ITA published to the general public that it is conducting investigation and taking measures against Israelis, who did not report their ownership of foreign bank accounts and the income thereof. Following to information obtained and gathered by the ITA regarding these bank accounts owners, the ITA started to execute extreme measures against them, by arresting them and/or summoning them to inquiries. The ITA also published to the general public information regarding the bank accounts owners, who has been arrested. The arrest and questioning by ITA investigators constituted a (traumatic) event that should have been avoided. This subject may be resolved within a voluntary disclosure proceeding program that was announced in September by the ITA, which offers, among other things, an opportunity for anonymous applications and negotiations. Through the voluntary disclosure proceeding, the applicant may be granted amnesty for possession of an unreported bank account overseas, thus sparing himself and his family anguish, to the extent

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that information about him reaches the ITA's investigators.

We must state, parenthetically, that recently, the belt has been tightening around Israeli residents who keep unreported overseas bank accounts, and the ITA is operating on all planes to receive information about them, for example through legislative amendments that will allow Israel to sign automatic information exchange treaties between with other countries.

Our office works extensively in providing service for Israel residents who keep unreported overseas bank accounts. Within the scope of our services, we perform an initial contact (in certain cases- anonymous) with the ITA in order to settle criminal and civil aspects. We recommend our affected readers to come as soon as possible for consultation concerning the voluntary disclosure program proceeding.

Tax credit in Israel for branch profits taxes that were paid abroad

An Israeli company that operates directly abroad, and not through a local company, may be subject to corporate tax (or equivalent taxes) for its income in a foreign country, subject to the provisions of the local tax law in that country and in accordance with the provisions of the relevant tax treaty, which usually provides for the first right of taxation when there is a permanent establishment in that foreign country.

In addition to the foreign corporate tax, there may also be branch profits tax liability to the extent that this tax is imposed in that foreign country. As a rule, branch profits tax constitutes an alternative to tax on dividends that would be imposed if the activity in the foreign country had been performed through a local company.

Three common options may be identified in which tax on profits distributions is imposed, whether on an annual basis or at the time of the actual distribution, in which the manner of imposition of the tax may affect the ability to credit it against the corporate tax in Israel, as set forth below:

Case 1: there are countries that impose branch profit tax on foreign companies that operate in their territory (usually with the existence of a permanent establishment), such as the USA and the Philippines. According to the domestic law in the USA, for example, branch profit tax at a rate of 30% is imposed, but in accordance with the tax treaty with Israel, this rate is limited to just 12.5% (the same as the withholding tax

rate apply on dividends in accordance with the treaty).

We must point out that in the USA, branch profits tax is imposed each year on the profits of the branch (except for amounts that were used for reinvestment in a business under certain conditions). We must also point out that in many cases, including in the absence of a permanent establishment in the USA (such as passive possession of real estate), a foreign company would opt for tax liability as though it were a permanent establishment (instead of being subject to the high rate of the withholding tax) and therefore will be liable for branch profits tax. In effect, branch profits tax is considered to be a second tier of the U.S. corporate tax that is imposed on activity in the USA.

In view of this, it is our position that branch profits tax that is paid in the USA will be credited against the Israeli corporate tax.

Case 2: In certain countries, it is common practice to impose on a foreign company, a corporate tax at a higher rate than the corporate tax imposed on a local company. In Congo, for example, the corporate tax that is imposed on a foreign company that operates in its territory is at the rate of 35%, compared to the rate of 30% that is imposed on a local company. The difference in the corporate tax rate that is imposed on a foreign company compared to a local company effectively constitutes an alternative to branch profits tax. However, in our opinion, regarding the right to receive foreign company tax credit, there is no doubt that this tax is fully credited against the corporate tax in Israel, including the transfer of credit surpluses to upcoming years in accordance with the provisions of the Israeli income tax ordinance (hereinafter: "the **ITO**").

Case 3: There are countries that impose tax on the distribution of profits that are classified as dividends to all intents and purposes, even when these profits are not classified as dividends in the recipient country of residency. For example, in Spain, the distribution of profits by a local partnership to an Israeli company will be subject to a withholding tax as though they were dividends, whereas in Israel, these profits distributions are not classified as dividends income, due to the transparency regime that applies to partnerships. Thus, it may be argued that the Spanish tax on profits distribution cannot be credited in Israel because the profits distribution is not classified as a distribution of dividends in Israel. It is our opinion this tax should be considered as part of the Spanish corporate tax, because its similar nature to the branch profits tax that applies to the profits of the Israeli

company through the partnership (similar to our position concerning branch profits tax in the USA). In order to enjoy the foreign tax credit in the year the income was derived and its taxation in Israel, the Israeli company must be kept to the statutory time limit for payment of the foreign tax - no later than twenty four months after the end of the year in which the income from the partnership was taxable in Israel - and in effect it must make sure that the profits of the partnership are distributed during that period.

In view of this, it is important to examine the aggregate of the taxes that will be imposed abroad on an Israeli company that operates abroad, whether through a branch, a local company or partnership, including the examination of the existence of a permanent establishment and the feasibility to receive credit for foreign taxes that have been paid abroad.

Reporting duties by the trustee and by the settlor upon the immigration of the settlor to Israel

Under the new provisions in the ITO regarding trusts, a trust which includes a settlor who is a foreign resident and a beneficiary who is a foreign resident, is classified as a Foreign Residents Trust that is not required to report in Israel (to the extent that there are no taxable income in Israel).

What happens when the settlor of the trust immigrates to Israel? May his immigration impose reporting duties on him or on the trustee?

Upon the fulfillment of the major required conditions, the trust may become, upon the immigration of the settlor, a Foreign Resident Beneficiary Trust, assuming that the required irrevocability conditions are fulfilled (for example, the beneficiary of the trust not being a minor child of the settlor). However, in a Foreign Resident Beneficiary Trust, the trustee is required to submit an annual notice (even if he is not required to submit an annual tax return) using a specific form indicating that the trust is a Foreign Resident Beneficiary Trust, along with a notice on an additional specific form indicating that it is an irrevocable trust. A parallel duty applying to the settlor in the circumstances described was postponed within an amendment to the tax law as set forth below.

The question that is asked is whether the status of the settlor as a new immigrant (who by himself is exempt from tax and reporting on his assets and income outside of Israel for 10 years from the time of his immigration to Israel) does not grant the relieves in reporting that are given to him, to the trustee himself too.

Certain relieves concerning trusts and new immigrants may be found in the provisions of the ITO or in professional circular that the ITA has published on this matter, for example:

- According to the provisions of the ITO, the settlor of a trust must report the creation of a trust in the year of its creation, but a settlor who is a new immigrant is to submit such a notice only ten years after his immigration;
- The provisions of the ITO combined with the guidelines of the ITA that was given within guidelines that were published on the subject of trusts, exempt a trustee from submitting an annual report for a trust that became an "Israeli" following the immigration of a settlor or a beneficiary, although the case presented above is not one of the cases stated in those guidelines, in our opinion only due to inattention;
- In a professional circular that was published on the subject of relieves for new immigrants and returning residents, a number of clarifications have been published that prescribe an exemption from reporting and submission of other forms for a new immigrant that relate to incomes and assets outside of Israel, even if that exemption was not explicitly given within the law.

It is our position that in view of the purpose underlying the "Immigrants Law" (encouragement of Immigration and removal of barriers), **the Immigrants Law eliminates the duty to submit the reports and notices set forth above, both by the settlor and by the trustee in a trust that has become "reportable" upon the immigration of the settlor to Israel** as described above.

In addition, we stand behind our position that the purpose of the trusts chapter's legislation in the ITO was to eliminate the tax advantage for holding assets through a trust compared to directly holding the assets and to create tax neutrality, to the extent possible, between the two situations. It is our position that there was no intent of worsening the situation of the tax payer only due to the fact that his assets are held by a trustee. And indeed, if the new immigrant were to hold his assets overseas directly or transfer them to his children (the beneficiaries of the trust) directly, there would be no reporting liability concerning them upon his immigration to Israel.

Moreover, even if the trust were classified as an Israeli Residents Trust upon the immigration of its settlor to Israel, the trustee would still be exempt from the duty of submitting reports and notices during the dispensation period (lasting 10 years), let alone, the legal situation should be such with respect to a Foreign Resident Beneficiary Trust too.

Our conclusion in the context of the example that was given is **that the duty to submit notices as set forth above by a trustee exists only in the first tax year after the end of the ten year benefits period starting from the time of immigration of the settlor to Israel.**

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

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