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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 first quarter of 2016

Selected Issues:

- Immigrating to Israel, even from a treaty country, does not necessarily sever residency of the country of origin.
- Trust the treaty - the meeting between trusts and treaties.
- Section 97(B3) before and after: a blessing that proved to be a curse?
- Double taxation in a treaty country - under the cover of law.

Tax News Alert No.23 - April 2016

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.

Immigrating to Israel, even from a treaty country, does not necessarily sever residency of the country of origin

The State of Israel is a country that absorbs immigration, and many immigrants, including many from France, enjoy significant tax benefits in Israel (generally speaking - an exemption from tax and reporting for 10 years from the date of immigration). However, when a new immigrant or a long term returning resident ("qualified individual") does not sever his tax domicile from his original country of residency and remains a taxpayer there on a worldwide basis, the relevance of these benefits diminish greatly (the same applies to immigrants from the USA, who despite severing their American residencies, remain subject to tax on a worldwide basis in the USA based on their citizenship).

Section B4 of the French tax code (CGI) states that an expatriate individual will remain a tax resident of France if one of the following applies to him: (1) his primary home is in France (similar to the permanent home test); or (2) he performs work or grants independent services in France (unless this activity is only concomitant); or (3) the center of his economic interests is in France (this test is usually fulfilled if most of his incomes are generated in France); or (4) he stays in France for 183 days or more in the tax year. In June 2015, France's supreme administrative court (the Conseil d'Etat) ruled concerning an individual who had moved to Cambodia (he worked there voluntarily and maintained his tax domicile there), but

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his sole income was a French sourced pension, that his economic interests were centered in France and he therefore remained a France resident under domestic law. In this case, the individual requested to continue to be considered a France resident, due to the fact that the pension that he received from France was subject to withholding tax applying to foreign residents, which was greater than the tax burden that the individual would have paid had he been considered a France resident. The tax authorities argued that a French sourced pension was not enough for the individual to be considered a France resident, inter alia based on the explanation that his pension did not constitute compensation generated from economic activity that was carried out in France. Two judicial instances (the Administrative Court and the Appellate Administrative Court) supported the position of the tax authorities, but as noted, the supreme instance ruled otherwise. We should note that Cambodia and France do not have a Tax Treaty between them. The implementation of the tiebreakers of a commonly worded tax treaty (such as the OECD model convention) would have probably led to the decision that the individual was not a resident of France.

It would seem that when implementing tiebreaker tests according to the provisions of the treaty between Israel and France for a qualified individual from France in a case similar to that described above, Israeli residency should be determined. However, Israeli individuals who have qualified individual status, and therefore are exempt from tax on incomes generated abroad, may have difficulty concerning eligibility for treaty benefits. This is due to the definition of the term "resident of a contracting state" in the OECD model convention and in most treaties that Israel has signed, whereby this term does not include a person (in our case, the qualified individual) who is subject to tax in that country (Israel) only concerning income sourced in or capital located in that country (Israel). This makes it important to sever residency according to the <u>domestic law tests</u> of the country of origin (and in the example above - France) and strengthen the legal and factual arguments that would lead to the application of the relevant tax treaty.

Trust the treaty - the meeting between trusts and treaties

The trusts chapter in the Income Tax Ordinance (ITO) came into effect in the 2006 tax year and underwent significant legislative amendment effective from the 2014 tax year. In general terms, the trusts chapter gives a trust a status of a taxpayer for tax purposes and considers the assets and incomes of a trust as being held or generated by an individual. The residency of that virtual individual is determined by the trust classification.

For example, for an Israel Residents Trust (including an Israel Resident Beneficiary Trust that is not a Relatives Trust) that "individual" is considered an Israeli resident and the trustee is taxed accordingly. The question arises, how the provisions of the trusts chapter and the taxation thereby dovetail with the tax laws in overseas countries and with the provisions and effect of the tax treaties. Some foreign laws recognize the existence of certain entities that are intended for keeping and managing assets under trust schemes, such as a foundation. In some cases, those trust entities are considered a resident in the country in which they were incorporated and/or in which they are managed. The Israeli legislator and the Israel Tax Authority (ITA) recognize the existence of such entities as trust schemes. Thus, for example, the Addendum to the ITO, lists such entities and classifies them as a trustee for the trusts chapter's purposes. In addition, in Taxation Decision 6893/15, a similar entity of "establishment" type was referred to as a trust or as a trustee and the taxation treatment corresponded with that classification. A clash of laws may occur when such a trust entity is considered a resident of a foreign country, but is assessed as an Israeli resident individual in accordance with the provisions of the ITO. This situation forms grounds for double taxation, particularly when incomes are generated in a third country and the taxation rights of one of the countries depend on the identity and residency of the taxpayer. Tax treaties include "tiebreaker" clauses for determining a residency (when double residency occurs), but it is not at all clear whether this must be ruled according to the provisions applying to an individual (inasmuch as according to the provisions of the ITO, a trust is treated as an individual) or according to the provisions applying to a person who is not an individual. Usually, the latter is implemented for determining a residency of a company, but to the extent that the rule also applies to a trust, its residency will usually be determined according to the place of effective management. In such a case, to the extent that the effective management is situated in the foreign country, **it may be argued that the incomes of the trust are not taxable in Israel pursuant to the provisions of the treaty**. An interesting question would be concerning the tax liability of distributions from that trust entity, because these are not classified as a dividend according to the provisions of the ITO and on the other hand distributions from a trust are not taxable by the beneficiaries (except for a "Relatives Trust" in certain cases). In the recently signed treaties, Israel has been trying to relate explicitly to the determination of trust's residency in the residency clause, such as the new treaty with Malta, thus giving more relevant tools for determining residency of entities or arrangements of this type. A clash between the provisions of the

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ITO and foreign tax laws may also arise in the context of a trust's "Underlying Company" (a company that its sole purpose is to hold the trust's assets on behalf of the trustee). Such a company is not considered as a resident of Israel for tax purposes and effectively it is disregarded for tax purposes, and therefore the residency clause in the treaties is not relevant to it. However, it is possible for such a company to be considered a resident of a foreign country, meaning that problems may arise primarily in all matters relating to the possibility of receiving a foreign tax credit on tax paid in the foreign country, including by way of tax withholding from profits distributed by it to the trust.

Section 97(B3) before and after: a blessing that proved to be a curse?

In 2005, a temporary order was added to the Income Tax Ordinance (ITO), within Section 97(B3) of the ITO, granting a foreign resident of a treaty country an exemption from capital gain tax upon the sale of securities of an Israeli company (or a foreign company whose assets are mostly in Israel). The said exemption applied only to securities that were acquired in the period from July 1, 2015 to December 31, 2008 ("the temporary order period"). The temporary order prescribed a number of additional conditions such as the duty of reporting when a security is purchased, conditions concerning required time period as a resident in the relevant treaty country and more.

Within an amendment of the ITO effective from January 1, 2009, aimed to expand and fixate the said exemption, the wording of the previous section was cancelled and the new version ruled that any foreign resident would be entitled to an exemption upon the sale of a security of an Israeli resident company, irrespective of the foreign resident being a resident of a treaty country/ The new clause provisions regarding entry into force state that it will apply to the sale of a security purchased on January 1, 2009 or later. Because there is no "grandfather clause", it may be asked what is the legal situation regarding securities purchased in the period of the temporary order and sold after the amendment. **It would seem that due to the cancellation of the previous clause in the above mentioned amendment, according to the provisions of the law as worded, a treaty country resident who purchased a security of an Israeli company in the period of the temporary order who is now interested in selling the security, will not be exempt from capital gain tax at the time of sale, even if he would have been exempt from it had he sold that security by December 31, 2008.**

The commentaries to the law, which express the intent of the legislator in the said amendment, state that the purpose of the section is to encourage

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foreign residents to invest in Israel. It further states that to encourage foreign residents to invest in Israel, the provision of the law that limited investors only to treaty country residents was cancelled and the provision of the law that required the purchaser to immediately report on the purchase - was cancelled. It is clear to us that the intent of the legislator behind the said amendment was to encourage foreign residents to invest in Israeli companies, beyond the benefit given within the temporary order, and the commentaries also stated that: "Giving such an exemption in Israel will allow companies in Israel to compete with companies abroad over the investment of foreign residents". However, the law itself and the commentaries do not answer the question of whether the exemption also applies to a foreign resident who purchased the securities before 2009. **In our opinion, it is obvious that the purpose of the amendment was to continue the existing exemption while giving additional relieves to foreign residents for new purchased of securities, and therefore it is to be interpreted so that an exemption will also be given to those who purchased the securities in the period of the temporary order and according to the conditions prescribed therein, even if the securities were sold after it.**

Double taxation in a treaty country - under the cover of law

The profits of a controlled foreign company (CFC) that constitute the basis for a deemed dividend are derived, in the case of treaty countries, from the tax law in that country, according to the definition of the "Applying Tax Laws". This definition was changed within Amendment 198 to the Income Tax Ordinance (ITO), effective from the 2014 tax year, within which it was stated (inter alia) that deemed expenses that are not recognized in the generally accepted accounting principles (such as deemed interest) are to be neutralized. The purpose that the legislator intended to achieve in that amendment is equalizing the profits of the company that enjoyed such a beneficial tax regime to those that would have been determined had it not been calculated under that beneficial regime, and thus make those profits consistent with the accounting or cash flow profits that were actually distributable as dividends to the shareholders. For example, such a company whose passive profits are 100, but was entitled to a total of 80 as a deemed interest expense for tax purposes in that country (despite such expense not having paid and not due to be paid ever in the future), will be able to distribute an actual dividend of 100 rather than just 20, and therefore the neutralization stated above achieves the desired effect. Conversely, it is known that many countries have restrictions and limitations concerning the deductible financing expenses. Sometimes the

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limitations relate to loans from related parties and sometimes to all financing expenses of the company, usually it is a case of a permanent difference. Usually these are thin capitalization rules within which interest will be deductible to the extent that a specified equity-debt ratio is obtained. In recent years, instead of or in addition to these rules, many countries impose additional restrictions, such as: setting a limit for deductible interest expenses as a percentage of EBITDA, or setting a limit to the interest rate that may be determined for a loan to a related party. One may ask how such genuine financing expenses (that have been actually paid) that were not deductible in the (treaty) country of residence by the company that is classified in Israel as a CFC are being taken into account. Meaning, further to the example given above, we assume that the profits of the company are 100, and it has actually paid interest at the amount of 80 to a local bank from which it took a loan. Within the company's tax return only 30 out of 80 was a deductible expense. The profits of the company in that year, for accounting and cash flow purposes, total at 20, and this is the amount that it may distribute as a dividend to its shareholders.

However, according to the "Applying Tax Laws" definition, the profit to which the CFC provisions will apply is 70 (100- 30), that is the taxable income in that country.

In our opinion, in such cases, the CFC provisions of the ITO should be interpreted according to their purpose and a controlling shareholder of a CFC should be taxed merely on the profit that he could have received as a dividend (in the example above – 20), because in the current legal situation described, the controlling shareholder is taxed on incomes that he and/or the company have not received and will not actually receive. The distortion is worse when the interest expenses that were not deductible by the company are those paid to the controlling shareholder himself, meaning that in Israel the controlling shareholder is taxed twice for that income amount that was not deductible by the company (in the example above – 50), firstly as actual interest incomes and secondly as a deemed dividend (under the CFC provisions).

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

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