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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 Forth quarter of 2016

Selected Issues:

- Update on forthcoming changes in tax legislation
- Trusts: "Once a Beneficiary, Always a Beneficiary?"
- Residency: Emphases for management and control tests
- Tax Treaties: Internal tax laws versus treaty provisions

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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.

Update on forthcoming changes in tax legislation

We wish to inform you of forthcoming changes in legislation in the wake of the Economic Efficiency bill (legislative amendments to achieve budget goals for 2017 and 2018), - 2016. The legislative amendments are currently under discussion in the Israeli Knesset Finance Committee, and are planned to enter legislation after the aforementioned law is approved in the second and third reading by the Knesset. It should be noted that the bills described in the following could be modified in the final legislation brought before the Knesset plenum.

A. Multiple Apartment Tax

As part of the government's efforts to combat the rise in residential property prices in Israel's economy, and to increase the supply of residential apartments, a new tax has been proposed, to be imposed on owners of three or more residential apartments ("**Multiple Apartment Tax**"). The aim of Multiple Apartment Tax is to motivate owners of several investment properties to sell some of these apartments. The government thus seeks to increase the supply of residential apartments in Israel's economy.

The bill as it is know today includes imposing Multiple Apartment Tax on whoever owns at least three apartments, where the tax shall apply from the third apartment, and the maximum tax paid on each apartment shall not surpass ILS 18,000 per annum (approximately USD 4,500). The tax is calculated according to a formula set out by law, and is derived from the value of

the apartment and other criteria. As far as we know, the Multiple Apartment Tax shall apply to whoever holds 249% cumulative ownership of residential apartments; in other words, 2.5 apartments. The taxpayer may choose which apartment the above tax shall apply to; if not, this shall be determined by the Tax Authority.

It should be noted that from the press release made by the finance committee before the final draft of the law discussed in the committee was publicized, it is evident that the Ministry of Finance agreed to a compromise, according to which Multiple Apartment Tax shall not apply to apartment owners whose two additional apartments are valued at up to ILS 1.15 million (approximately USD 285,000).

Furthermore, according to the bill, it follows that whoever became the owner of three apartments or was removed from this definition over the current year will only be taxed partially for each of the apartments he owns, taxable under the Multiple Apartment Tax, corresponding to the part of the years the apartment was owned by him.

B. **Forced Distribution of Company Surplus - Section 77 of the Income Tax Ordinance**

Section 77 of the Israeli Tax Ordinance, in its current version, permits the director of the Israeli Tax Authority (the "**Director**") to order a company to distribute its undistributed profits to the extent that the terms of the section have been fulfilled, including: a. The company is a closely-held corporation (a company under the control of no more than five people); b. The company has not distributed its profits as a dividend to shareholders until 12 months from the end of the tax years; c. The distribution of all or some of the profits shall not jeopardize the existence of the company or compromise the development of its business; d. The results of non-distribution is avoiding of tax or reduction in tax. The authority of the director to order distribution is limited to a period of three years after the 12 month period from the end of the tax year, to which the distribution of profit would be applied, and after the director has consulted the committee on the matter. The aforementioned section shall not apply when a company has distributed at least 75% of its taxable income.

In practice, the director makes very little use of the aforementioned section, due to the need to consult a committee for this purpose. In addition, the director's authority to order a forced distribution expires three years after the end of a given tax year.

In light of the accumulation of profits by Israeli companies not distributed to shareholders, for no economic purpose connected with company business, it has been proposed to

amend the section in order to give the director the authority to order distribution of profit with no economic purpose in the company.

According to the bill, it is proposed to enable the director to order distribution of profits in a company, if it has not distributed at least 50% of its profits over a period of five years from the tax year under discussion. The distribution shall apply to a company which has amassed over ILS 5 million cumulative profit (approximately USD 1.25 million), and only if its cumulative profit is no less than ILS 3 million (approximately USD 0.75 million) after distribution of cumulative profit with respect to the tax year under discussion. The authority of the director to order the distribution is not limited in time, and he may do so five years have lapsed since the end of the tax year for which the distribution of profit is being examined, and with respect to the entire balance of surplus accumulated until that year from the day the company was established.

C. **Deemed dividend distribution in certain circumstances**

The aim of this section is to deal with the phenomenon of withdrawal of funds or assets from the company by its shareholders, without them having been distributed to shareholders as dividends, and without their being returned to the company for long periods of time or without being returned at all. Withdrawals from the company are classified by its shareholders as a loan to be returned to the company. Under the current law, owners' withdrawals are taxed on income valued at the rate of conceptual interest or land use fee; however, the latter are not equivalent to the tax that would be owed if the funds or assets were distributed as a dividend to shareholders.

In light of this, an amendment to the Israeli Tax Ordinance was proposed, according to which withdrawal of funds or assets, including loans granted to related companies (i.e. placing an asset at the disposal of shareholders or their relatives) by a substantial shareholder or his relative shall be considered income from dividend, salary, business or profession to the shareholder, according to the circumstances. For example, if there is a balance of profit for distribution in the company, the deemed income shall be classified as a dividend. If the company has no profits for distribution, and employer-employee relations exist between the substantial shareholder and the company then the income shall be classified as income from wages;

if no employer-employee relations exist then the income shall be classified as income from a business or a profession.

In the case of withdrawal of funds from the company, the date of taxation shall fall at the end of the

tax year following the withdrawal of funds; in the case of use of company assets, the date of taxation shall fall at the end of the first year of use of the asset, and at the end of each of the following years, until the date on which the asset is returned to the company. It should be noted that until the date of taxation for a withdrawal or use of company assets, the said provisions shall apply - attribution of conceptual interest income to the shareholder, or attribution of income with respect to market price of use of asset.

As noted above, the aforementioned has been taken from the bill and amendments to it while under discussion in the finance committee and are subject to change, for as long as the final bill to be debated in the Knesset towards the second and third readings has not been publicized. We shall update you in the upcoming quarterly tax alert on the final changes in legislature approved by the Knesset.

Trusts: "Once a Beneficiary, Always a Beneficiary?"

The newly published income tax circular on taxation of trusts includes many provisions on taxation of trusts, and the Israel Tax Authority's interpretation to a major part of them. It appears that the Tax Authority is highly suspicious with regard to cases in which, in the past, Israelis were beneficiaries in trusts, and the guideline throughout the circular in such cases was that removing an Israeli beneficiary from the list of beneficiaries in a trust apparently constitutes illegitimate tax planning. In several sections in the circular, the Authority clarifies to whom its approach applies, i.e. the definition of a beneficiary in a trust.

- Referring to the definition of a beneficiary, it is written that: "A person shall be considered a beneficiary in a trust, whether he received an actual distribution from a trust or whether he is or was in the past registered as a beneficiary in the trust documents."
- With regard to a Non-Israeli Resident Trust, it is written that: "In cases in which a beneficiary in a trust was once a resident of Israel, and that beneficiary **passed away or ceased to be a resident of Israel before the tax year of 2003...**" The trust shall be classified as a Non-Israeli Residents Trust, despite the fact that there was once a resident of Israel in it"; and further on it is written: "...When in a trust there was once a beneficiary, a resident of Israel who, in the wake of a change in the provisions of the trust documents ceased to be a beneficiary in the trust, the trust shall not be classified as a Non-Israeli Residents Trust rather as an Israeli Residents Trust or Relatives Trust...".

When examining the provisions of the Income Tax Ordinance defining the beneficiary in a trust as "a person

entitled to benefit, directly or indirectly, from the trustee's assets or income, including those...", one could conclude that the aforementioned assertions by the Authority are not grounded on existing legislation. The law makes no mention of the assertion that a beneficiary remains a beneficiary in the trust, even after having been removed from it.

Furthermore, this assertion by the Authority is in contradiction to the general trust laws that enable removal of beneficiaries, at the discretion of the trustee or creator, or with the fulfillment of certain conditions. Thus, for example, in many cases the spouse of a main beneficiary is included as a beneficiary in the trust, for as long as the couple are married; hence, in the event of divorce the spouse shall cease to be a beneficiary. If the removed beneficiary was a resident of Israel, would the trust still be considered an Israeli Resident? Is the passing of the removed beneficiary the only remedy for fixing the Israeli status of the trust? Here we have a motive in a potential homicide case...

This decision by the Authority as to who a beneficiary is, could create a number of absurd situations: According to the circular of a trust whose creator is a foreign resident, which on the day of formation had two beneficiaries, one non-Israeli and the other Israeli, and in 2004 the Israeli beneficiary transferred his residence to a foreign country; this trust shall still be considered an Israeli Trust (Relatives Trust) despite the fact that for the last 13 years there has been neither an Israeli creator nor an Israeli beneficiary! A similar law shall apply in a situation in which an individual creates a trust for his own benefit, and subsequently severs his Israeli residency. According to the Tax Authority's approach it looks as though the trust shall continue forever to be "Israeli".

In several examples included in the circular, it appears that the Tax Authority rejects the status of non-Israeli residence for a trust, due to a past Israeli characteristic. The aim, apparently, is to preclude potential cases of artificial transactions through categorical decisions, without the need to cross the hurdle of proving the fact that the taxpayer has carried out an artificial transaction.

On this matter, it is clear that change of residency cannot disguise itself as tax planning. This would be comparable to an individual leaving Israel and the Tax Authority deciding that he shall forever be considered a resident of Israel, since the very change of residency constitutes tax planning, designed to reduce his taxable income in Israel.

Residency: Emphases for management and control tests

According to Israeli tax laws, a company is considered a resident of Israel if it has been incorporated in Israel or if management and control of its businesses are performed in Israel. The Tax Authority has recently publicized clarifications on the matter of management and control of companies from Israel, including general background on rulings recently publicized on this issue, as well as emphases and guidelines for action required when examining the place of management and control of a company.

The rulings discussed in the amendment are the Niago case (Civil Appeal 3102/12); Yanko Weiss (Civil Appeal 805/14) and the Shay Tzamarot case (Civil Appeal 32172-05-13).

In principle, the amendment does not include any substantial innovations with regard to analysis of the term 'management and control'; however, the concentration of facts and decisions lying at the foundation of the rulings, and formulation of guidelines for action constitute an effective tool in the hands of taxpayers and representatives who wish to examine the issue in the context of their businesses or customers.

The main emphases including our comments, in a nutshell, are as follows:

1. In the present technological era, the existence of management and control may be carried out "by remote control"; thus, residency of directors and location of board of directors meetings is of no great importance. Nevertheless, it should be added that to the extent it becomes clear that the process of making substantial decisions (as opposed to the act of making the formal decision itself) is performed outside of Israel, among other things, as part of convening the board of directors, this may establish management and control outside of Israel.
2. The existence of foreign directors and managers does not in itself indicate management and control outside Israel, if this involves people who are not knowledgeable in company affairs, and do not wield the authority actually applied in making significant decisions for the company. Furthermore, the Tax Authority attributes importance to the salaries earned by executives, assuming that whoever is given the authority (and responsibility) to make decisions is entitled a worthy salary for it.
3. The identity of the holders of controlling interest in the company, or those of another company providing management services to the company under examination, should be examined, and it appears that the Tax Authority attributes importance to their residency. Nevertheless, in the aforementioned rulings it says that the fact that the decision maker is a resident of Israel does not determine management and control from Israel, and the place where this company makes its decisions should be examined.
4. Day-to-day decisions are not

necessarily merely "technical" ones, and may very well create management and control from Israel (assuming they are made there) if and to the extent this involves decisions that determine the company's modus operandi. Thus, for example, a local executive who makes business decisions on a daily basis will be able to establish management and control outside of Israel if these decisions are essential to the company's business; there is no requirement that this local executive must be the one making the strategic decisions (such as the board of directors).

5. The fitness, experience, and familiarity with the company business of the person purported to be its CEO, or whoever determines the way it conducts its business, should be examined. Thus, for example, it should be examined whether it is a management body providing management services to additional factors; in such case it could be that the involvement of that executive or body in the company's business is not deep enough.

Tax Treaties: Internal tax laws versus treaty provisions

We often encounter the issue of the combination of treaty provisions designed to prevent redundancy, and the provisions of the tax ordinance in Israel. The basic principle that applies here is that the provisions of the treaty supercede those of the internal law. A qualification for this rule is that in cases where treaty provisions worsen the taxpayer's situation, the more lenient provisions of the internal law remain in force.

One of the subjects affected by the issues of the combination between ordinance provisions and treaty provisions, is that of residency for tax purposes. We shall give three examples:

1. Foreign Professional Company (FPC): This is in essence an anti-planning provision that determines that the income of a foreign company from professional activity (such as services) performed by its Israeli shareholders is subject to tax in Israel, payable by those shareholders, as a deemed dividend. A circular recently publicized deals, among other things, with the definition of such a company.

   The basic condition is that this involves a foreign company. The circular discusses a case in which a company is considered a resident of Israel in accordance with Ordinance provisions (for example, when the company has been incorporated in Israel); however, in light of the provisions of the relevant treaty, the company is considered a resident of the treaty country (in light of the tie breaker rules applied with regard to a company, usually a test of the effective place of management).

   In such a case, **the circular**

determines that a company should be seen as a non-Israeli company, even if this decision derives from the treaty provisions only; therefore, the relevant anti-planning provisions shall apply to its shareholders.

Another interpretation may lead to the conclusion that on the one hand the company shall not be taxed in Israel for its income outside of Israel (since according to treaty provisions it is not a resident of Israel) and on the other hand the FPC anti-planning provision shall not apply (since this does not involve a non-Israeli company according to Ordinance provisions).

2. Exit tax: How are the exit tax provisions stipulated in Israeli law applied, in the event in which a person is still considered an Israeli resident according to the provisions of internal law, since he has not yet transferred the center of his life to the relevant foreign country; however, the same individual is already considered a resident of the treaty country according to treaty provisions (the tie breaker rules in the residency section). The question asked is, what law applies in a case in which that person, during the same "twilight period", sells an asset he had abroad. If it is claimed that exit tax provisions do not apply, since pursuant to internal law the status of residency remains unchanged, then at the sale's stage no tax shall apply in Israel, since that person is not a resident of Israel according to treaty provisions, and in any case is not seen as one who has sold the asset prior to severance of his residency. If the Tax Authority should claim that change of residency, according to treaty provisions alone "triggers" the exit tax, then the portion of capital gains attributed to the period of Israeli residency may be taxed at the sale's stage, according to a linear mechanism. **The Tax Authority hasn't published an official announcement of its stance on this matter; however, to the best of our knowledge, its position is that the exit tax applies even if the change of residency is according to treaty provisions only.**

3. New immigrants: Let's assume a case of an individual gradually returning to Israel from a treaty country after living there for nine years. We assume that at that time, according to the Israeli Tax Ordinance provisions he is considered a resident of Israel; however, according to the tie-breaker rules in the residency section, for the next two years he shall still be considered a resident of the treaty country; in other words, according to both the internal law and the treaty, the individual is considered a non-resident of Israel for 11 years. Will those two years in which the individual is considered a non-Israeli resident according to treaty provisions only, lead the individual to "safe shores" as a "veteran returning resident" (a unique status given an individual who was a foreign resident for at least 10 years is exempt from

tax and reporting for 10 years)? The Tax Authority's position on this matter is negative, as publicized in the professional circulars and decisions on taxation with regard to this issue, and as its aforementioned position – that the non-Israeli residency period according to the treaty only shall not be included in seniority counted for the purpose of determining the status of a "veteran returning resident"; this status shall be determined only if the individual was a non-Israeli resident according to Israeli Tax Ordinance provisions for the required period of time.

In our opinion, in light of the Tax Authority's stance on residency of a Foreign Professional Company as stated in Section 1 above, and its apparently similar stance on application of exit tax as stated in Section 2 above, cases of "veteran returning residents" should be treated analogously – counting years of non-Israeli residency under the treaty as non-Israeli residency under Ordinance provisions as well; and, as continued above, giving that individual benefits entitled to "veteran returning residents", since it doesn't make sense for the Tax Authority to seek to apply the rule only in cases in which tax may be imposed, and not apply it in cases where tax benefits are appropriate.

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

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