✓Artzi, Hiba, Elmekiesse, Cohen Tax Solutions Ltd.

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 2017

Selected Issues:

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.

Probably the last chance - new voluntary disclosure procedure

As is well known, since 2005, alternately and in different variations, citizens had the option existed for submitting a request to the Israel Tax Authority, to arrange and disclose data on income and assets that had previously been concealed, rather than disclosed as required under the law. **Disclosure as stated gave the taxpayer 'kosher certification' in the form of immunity from criminal proceedings.**

The last voluntary disclosure procedure terminated at the end of 2016. After discussion with the state attorney, a new voluntary disclosure procedure was published - as a temporary order for two years, and in the case of submitting an anonymous request - for one year only.

It looks as though the temporary order for a maximum period of two years is designed to provide citizens a last chance to disclose their income and assets, before actual implementation of the results of agreements for exchange of information as part of the initiatives taken by the Europeans (CRS) and Americans (FATCA). According to these agreements, transfer of information from the United States is currently under way, with many other countries soon to follow suit, and provide information and data pertaining to the foreign income and assets of Israelis. We should note that the voluntary disclosure procedure applies to any kind of concealment of income and assets,

not only those located outside of Israel.

Procedure terms – the same as in the past, mainly – a full, honest application to the Tax Authority, a precondition that the Authority has no previous information and that no check or investigation has been made by the Authority with regard to the applicant and his immediate surroundings.

How to apply? As in the past, apply to the Deputy Director for Investigations in the Israel Tax Authority, as part of which the relevant information and further details will be provided. After approval, the application is transferred to the civil tax assessment office to arrange the applicable tax sum.

Anonymous application – the great advantage of the voluntary disclosure procedure is the option of direct, anonymous application to the Tax Authority, while disclosure of the taxpayer's identity is made only after an agreement is reached with the tax assessor's office with regard to the tax that applies in the specific case. Anonymous applications are submitted to the Deputy Director for Investigations; however, at his stage it cannot be thoroughly examined. The application is transferred to the assessor's office for discussion and negotiation without the taxpayer's details; these are revealed only after agreement is reached. Bear in mind that as part of this temporary order, an anonymous application may only be submitted over one year, i.e., until December 31, 2018, and a draft agreement should be reached within 180 days (with the option of extending this period).

"Short track" – suitable for small requests in which the arranged capital does not exceed NIS 2 million, and taxable income does not exceed NIS 0.5 million.

Please note: immunity from criminal proceedings shall not apply to those whose source of income is illegal activity; the Tax Authority will not give protection to those whose application is not honest, or failed to pay the tax agreed upon.

Another 'ambiguous' qualification to criminal immunity is "less than full cooperation in connection with the request". We note that this seemingly naive statement hides within it many potential risks for the applicant; hence he must conduct his affairs with caution. For example, a person who wishes to apply to the Tax Authority, but finds that his partner to that income does not agree to do so.

A person who has already in the past enjoyed the voluntary disclosure procedure shall not be entitled to do so it again. It is recommended that such cases not be 'left in limbo', and a taxpayer who has already performed the voluntary disclosure procedure and currently has what to disclose should

put his affairs in order.

In recent years, our office has arranged the assets and income of a great many clients, including individuals, companies and trusts. This is performed by a professional team made up of former Tax Authority professionals, who in their previous capacity were in charge of handling such applications. We will be glad to be at the public's disposal for any questions that may arise.

Cancelling the requirement for deduction at source for certain transfers of funds abroad

Many Israelis encounter considerable difficulty when transferring funds abroad in order to purchase assets, shares in foreign corporations, etc. This is because the Income Tax Ordinance determines compulsory deduction of tax at source for an Israeli paying a foreign resident, at the companies tax rate (currently 24%); or alternately 25% in the case of a foreign individual resident. The basic idea is to tax the foreign resident already when receiving income taxable in Israel.

However, certain kinds of transfers have no relevance to income taxable in Israel in the hands of the recipient, such as purchase of assets abroad or loans granted to foreign entities; those do not constitute taxable income in Israel. Thus, difficulties generated by the banks when making transfers abroad and the need to receive a certificate from the Tax Authority with regard to exemption from deduction of tax at source, have caused serious delays in making payments abroad and at times even harm to payment commitments.

As of late, the Israel Tax Authority has published a relief on this matter, according to which payments may be transferred to foreign residents with exemption from deduction of tax at source; this, by signing a suitable declaration on the stated application at the bank: The Tax Authority has compiled an application where, with fulfillment of all of the following conditions, the exemption will be given automatically, with no need for approval by the income tax assessing office.

1. The payment is made to a treaty country resident, and to a bank account in a treaty country (on this matter we note that it has not been determined that the bank account and foreign resident must be in the same treaty country);
2. The payment is for one of the following: Investment in shares, real estate or other tangible asset, as well as a loan to a foreign resident (including a shareholder's loan);
3. The application has been filled and kept by the bank, to be submitted to the Tax Authority by its request.

As part of the declaration, the transferor must confirm by signing that he is aware of the fact that the Tax Authority has the authority to determine deduction of tax at source in the case of any discrepancy between application details and actual transfer performed; in addition, the transferor must keep all references in connection with the transfer.

The definition of "treaty country" includes a list of 53 countries with which Israel has tax treaties. Since over the years, further tax treaties will been signed with additional countries, it is expected that this application form will be updated from time to time.

It is not superfluous to note that in transfers such as these, liability for deduction of tax at source should not have been imposed on the banks in the first place, since in Israel these are not defined as taxable income of the recipient; hence, there are no legal grounds for imposing tax or tax at source on it. Nevertheless, we see fit to congratulate the Tax Authority on the courageous change in and reduction of the stated practice. This move will make conducting international business easier, and we hope it continues pursuing this trend. We can only hope it will be improved inversely as well - when receiving funds from abroad in Israel, despite the fact that this falls under jurisdiction of the IMPA - Israel Money Laundering and Terror Financing Authority.

Should foreign companies profiting from sale of real estate and shares be counted as CFCs?

In a recently published ruling on the matter of Rosebud, the question of classification of income from sale of shares and real estate was discussed with regard to defining a CFC - Controlled Foreign Corporation.

Summary of the main facts of the case:

Rosebud Assets (Europe) Ltd. ("**the Company**"), a subsidiary of Rosebud Real Estate Ltd., an Israeli public company, holds full control of a subsidiary located in Holland ("**Rose**"), which has subsidiaries incorporated in Luxembourg. At the end of 2006, those Luxembourgian companies sold real estate for 134 million Euro without being charged tax abroad for the profit earned from the sale ("**Asset Sale Transaction**"). Furthermore, in August 2006, Rose purchased shares of Rosepark (a foreign company) which held an office building in Zurich, and two years later sold its shares ("**Share Sale Transaction**").

The dispute revolved mainly around whether the Asset Sale and Share Sale Transactions constituted passive income for the purpose of applying CFC rules, as claimed by the income

tax assessor who charged the company as if it received a dividend from Rose and the Luxembourgian companies; or, alternately, it was income from business, such that CFC rules do not apply, hence the company is exempt from being taxed in Israel? One of the fundamental conditions for classifying a foreign resident company as a CFC is either that "most of its income in the tax year is passive income or most of its earnings are derived from passive income".

Tax Authority's position:

Both the Asset Transaction and the Share Sale Transaction are classified as passive income: First of all, sale of an asset is considered passive since it terminates activity; secondly, the separate personality principle, i.e., each transaction is measured in the reflection of the company performing the sale; in other words, the return is from sale of an asset not used by the company in its business or occupation. Finally, the income tax assessor explained that the company was not taxed for the transactions made abroad; hence, it would be unacceptable for it not to be taxed in Israel either.

Position of the tax-paying company:

The income is active (from business): The holding of assets abroad through an international structure (i.e., through separate "Special Purpose Company") does not make the holding company a CFC; rather, an integral part of the group's activity including locating, purchasing, foreign financing, holding the asset, betterment and sale. All of these indicate characteristics of income from business.

Court ruling:

Since this is a single business enterprise dealing in locating, managing, betterment and sale of real estate, and since the funds from the sale were used by the group's sister companies through a dividend and loans, the court examined the income classification as business or passive and, in a precedential ruling, decided that with regard to application of CFC, with an overall view of the cluster of companies in the group, rather than the isolated activity of each individual company, the stated income shall not be seen as "passive income". Thus, the appeal by the taxpayer on this issue was accepted.

Further comments:

We note that, by the nature of things, the court did not address the amendment of legislation on the matter of defining "passive income" in CFC rules (carried out only in 2014). In the amendment it was decided that returns from sale of a security, even when constituting income from a business shall be considered passive income, unless the security was held for less than a year and it was proven to the income tax assessor's satisfaction that it served the company

in business or occupation. In other words, with regard to the Share Sale Transaction, the new rules reinforce the position of the income tax assessor since the Rosepark shares sold, as stated above, had been held for over a year.

In addition, it is worth noting that all CFC rules apply, as stated, to a foreign resident company. A foreign company controlled and managed in Israel becomes a resident of Israel, and owes regular Israeli companies tax. On the matter of examining the overall activity in the entire cluster starting from the apex – from mother companies in Israel to target companies abroad, the issue of "control and management" is liable to arise in the foreign companies. The Tax Authority has not raised an alternative claim on the matter of control and management from Israel; hence, the court has not discussed this matter despite having taken the trouble to illuminate it.

CFC aspects in a hybrid loan

The Dutch Ministry of Finance has published clarification with regard to classification for tax purposes of "inferior loans", i.e.: dead loans or long term loans (over 50 years): with regard to these, the lender is entitled partial or entire payment only in the event of liquidation or insolvency. In addition, his status is equal to that of shareholders in the company receiving the loan (as opposed to creditor status). The publication determines that interest from a loan as stated shall not be permitted with deduction by the borrowing company; however, the lending company may enjoy the Dutch participation exemption due to the "interest" it receives from it, on condition of meeting the regular terms of the participation exemption regime, and on condition of having applied in advance. We should clarify that regardless of the publication under discussion, since 2016, the income of a Dutch resident company may not enjoy the participation exemption regime, to the extent the income is deductible at the level of the paying foreign resident.

Examining the Israeli foreign controlled company (CFC) provisions:

In light of the aforementioned, it would be interesting to examine application of CFC provisions in Israel, with an Israeli resident holding a Dutch company which has income from inferior loans given by it. To calculate the income of the foreign company, resident of a country with whom Israel has a double tax agreement (**"Treaty Country"**) the calculation shall be made according to the tax laws of that country, but shall also include a <u>dividend or capital gain,</u> even if they are tax-exempt or not considered income according to the tax

laws of that country. The section does not relate to interest or other income, therefore it may learned that interest or other income removed from the tax base in the treaty country are not included when calculating the stated income, and will not be included as part of CFC provisions. We note that from the income tax circulars it is unclear whether calculation of the CFC income as stated adopts the tax laws in the treaty country only with regard to income sums or for classification as well.

Income received by a Dutch company from a dead loan:

When an Israeli resident holds a Dutch company and that company makes a profit from sale/transfer of a dead loan (or ordinary loan) then the action is subject to CFC rules since although capital gain is tax exempt in Holland, in Israel the profit is returned to the tax base for CFC, rules' purpose, as previously mentioned. When that Dutch company puts up a dead loan and receives "regular" interest on it, the Dutch publishing guidelines determine that this income is not classified as a dividend in Holland, nor is it clear whether it is classified as interest or as other income; however, it will enjoy the exemption (under the above terms) and not be included in the tax base in Holland. Therefore, this income will not be "returned" to the tax base and CFC provisions will not apply.

Interest participating in profits (profit participating loans):

The additional case mentioned in the Dutch publication is an inferior long-term (or dead) loan, for which interest depends on the profits of the lending company. In such a loan, payment (interest) will be reclassified in Holland as a dividend.

In such a case one needs to examine whether Israel absorbs the classification of the treaty country too, i.e., the income is classified as a dividend; CFC provisions shall then apply, due to the fact that the dividend is "returned" to the tax base. As opposed to this, if we say that Israel does not absorb the income classification of the Treaty Country, it may then be claimed that the income constitutes interest despite the Dutch classification and, as stated, interest is not "returned" to the tax base; therefore, CFC provisions shall not apply.