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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 2018

Selected Issues:

- Supreme Court ruling on foreign tax credit overturns lower court ruling
- Company or branch office? Considerations in determining the legal entity for business operations in Israel or abroad
- Digital currency taxation and ICO – Israel Tax Authority's position
- The Tax Authority's first taxation decision (ruling) on cryptocurrency

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.

Supreme Court ruling on foreign tax credit overturns lower court ruling

The Israel Supreme Court announced its ruling this month on the case of Gmul America Ltd. (CA 8934/16), concerning interpretation of Article 26, Relief from Double Taxation, of the Israel-US Tax Treaty (hereinafter the "**Treaty**"). The ruling overturned the District Court's decision on the case (Tax Appeal No. 49525-02-14).

The case in brief - Gmul America Ltd (hereinafter the "**Company**"), the respondent, realized a US capital gain in the tax year of the appeal (2006); US taxes were paid, the bulk in 2009. The subject of the appeal was whether a credit could be taken for foreign taxes paid in 2009, despite them having been paid after the 24 month period - a limit established in clause 207B of the Income Tax Ordinance for taking the credit in the relevant tax year (the year in which the income is declared in Israel).

The discussion in the District Court centered on the interpretation of the phrasing of article 26(3) of the Treaty, which requires Israel, under the circumstances, to allow a US tax credit against the Israeli taxes, where the credit shall be "*in accordance with the provisions and subject to the limitations of the law of Israel (as it may be amended from time to time without changing the general principle hereof)*". This phrase appears in the Model Tax Convention of the OECD, and

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in all tax treaties in which Israel is a partner. The question at hand was whether denial of the credit by internal law (deferring it to subsequent years as excess credit, in effect) is part of those same provisions and limitations of the law of Israel, or whether it changes the "***general principle hereof***" (relief from double taxation). The District Court ruled in favor of the company, by stating that the principle of relief from double taxation suffices to take precedence over the provisions of the internal law which limit granting of credit.

The Supreme Court ruling overturned this decision, and established that provisions regarding the offset period are within the realm of those provisions and limitations of the law of Israel, as established by the aforementioned article 26(3), and do not constitute a change nor an annulment of the general principle. The court found additional support in the fact that denial of the credit as established in clause 207B of the Ordinance is not absolute, and taxes paid beyond the required period could be granted as excess credit in subsequent years (in accordance with the principles laid out in the chapter on credit).

Company or branch office? Considerations in determining the legal entity for business operations in Israel or abroad

A question that often arises when considering a legal entity for international business operations is whether to set up a subsidiary in a foreign country or a branch office (i.e. permanent establishment); that is, direct company operation in the target country. This question also arises among foreign clients wishing to operate in Israel.

As with any tax-related issue, there is no single right answer; the specific circumstances must be considered on a case-by-case basis. We will attempt to address the main differences that could aid our readers in considering their own particular preferences:

1. **Corporate tax rate**: In general, a company's activity in a foreign country is subject to local corporate tax on its profits, regardless of whether it is a company or a branch office. A foreign subsidiary of an Israeli company pays its corporate taxes in its country of residence. A foreign company operating in Israel via a branch office pays Israeli corporate tax (23%) on the profits attributed to that branch.

   For a branch office, keep in mind that revenues derived outside the country of residence of the branch are generally not subject to taxes within that country. On the other hand, revenue of a subsidiary derived

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outside the country of residence are subject to tax by the subsidiary, since the taxation method is for the most part worldwide and not territorial, with certain exceptions (for example, the existence of participation exemption regimes).

There are additional considerations; for example, activity eligible for benefits by virtue of Israeli encouragement laws would require operation via an Israeli subsidiary (by the provisions of the encouragement law).

2. **Tax rate on distributions**: In addition to corporate taxes that would apply to a branch office or a subsidiary, distributional taxes need to be considered as well – whether on dividends distributed by a subsidiary, or distributions from the branch office to the parent company. In the US, for example, a branch tax is imposed on the branch's profits, equivalent more or less to the amounts that would have been distributed as dividends had it been a subsidiary. The tax rate that applies to the profits eligible for distribution of an American branch office is 12.5%, as per the provisions of the treaty with Israel. This rate also applies to dividend payout from an American subsidiary to its Israeli parent company.
On the other hand, profit sharing from an Israeli branch office of a foreign company does not require additional taxes since Israel has no branch tax. Dividends from an Israeli subsidiary to its foreign parent company are taxable in Israeli in accordance with provisions of the internal law (30%) or at a reduced rate as per the provisions of Israeli encouragement laws or relevant treaty provisions.

3. **Offset of losses**: According to Israeli law, foreign subsidiary losses may not be offset against parent company revenues, unless explicit provisions indicate such; an example of this could be a transparency regime for tax purposes that applies to the subsidiary (in relation to determining taxable revenues of the parent company). Losses associated with a branch office in a foreign country, under the conditions indicated in the Ordinance, may be offset against the company's revenues.

4. **Foreign tax credit**: In Israel, in general, keep in mind the foreign taxes paid by a branch office in a foreign country or by a foreign subsidiary, including taxes withheld from their dividend payouts. We will demonstrate this with an example of an Israeli company and an American company:
<u>Credit in Israel</u>: In the case of a subsidiary, foreign tax in Israel would

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be credited only at the time of dividend payout and not on a regular basis; furthermore, excess credit may not be carried forward to subsequent years (in accordance with the Israeli principles of "underlying tax credit"). In the case of an American subsidiary that paid, for example, 28% (federal and state) tax and pays out a dividend from which 12.5% was withheld, with total foreign tax (direct and indirect) at an effective rate of 37%, the Israeli company would not be required to pay additional taxes at the time of dividend payout, due to the credit granted, although the excess credit of 14% would not be carried forward to the following years.

Had it been a branch office, then the American corporate taxes paid by the branch office as well as branch taxes, also with an effective tax rate of 37%, would be granted (in our opinion) full credit from Israeli corporate tax, and the 14% excess could be used as an offset against taxes owed for other foreign-sourced revenues (on condition that they are in the same income basket).

US credit: In the other direction, an Israeli subsidiary paying out dividends to an American company would pay a total effective tax rate of 33% (corporate tax and dividend tax). This tax cannot be fully exploited by the American company because of the new tax regime (in effect from 2018) which grants a waiver to American companies for foreign-sourced dividends. In this sense it would be preferable for an American company to operate in Israel via a branch office, since in such a case only corporate taxes would be required – 23% (which would be credited from the American tax).

There are, of course, additional reasons for choosing this option over the alternatives presented above, including considerations of limiting responsibility and/or protection of intellectual property.

In any event, before beginning operations, consider the proper legal entity, taking into account the type of activity and the countries in question.

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Digital currency taxation and ICO - Israel Tax Authority's position

The digital currency scene has heated up in 2017 due to the great increase in value of digital currencies, as well as significant developments in the area – primarily the wave of new "token" offerings that have joined the existing ones; as a result, today's trading platform includes some 1,600 different currencies.

Professional circular published by the Israel Tax Authority ("ITA")

In addition to position 2017/32 which summed up the Authority's position on classification and taxation of digital currencies, the ITA has published two circulars on the topic:

Circular 5/2018: **Taxation on decentralized method of payment activity (entitled "virtual currency").**

Circular 7/2018: **ICO - Initial Coin Offerings for service provision and/or products in development (Utility Tokens).**

Circular 5/2018 ("Virtual currency taxation circular") distinguishes currency used as a "**decentralized method of payment**" - referring to Bitcoin, Litecoin or any other "coin" based on a unique platform, from a "**decentralized smart contract**" ("tokens") which constitutes a group of tokens that exploit an existing platform, such as Ethereum.

The Virtual currency taxation circular establishes the tax principles only for the second class of currencies - the "tokens" (decentralized smart contracts). Below are the main points of the circular:

1. Virtual currencies are not considered "currency" - this is the Authority's position; a consequence of this position is that the linkage differential exemption that exists for individuals in Israeli law for ordinary currency ("fiat" money) may not be exercised in this case. This position of the Authority is based on the definitions in the Bank of Israel Law. **We would like to stipulate that our office maintains that virtual currency is in fact currency, and an individual therefore would be eligible for exemption due to an increase in value.**
2. Virtual currencies are "assets" - a consequence of this position is that their sale is subject to capital gains tax. **Based on our aforementioned position that these are in fact "currencies", our position is that an increase in their value would be tax exempt.**
3. Currency activity at a "business" or mining level is classified as business income - consequence of this position is that their sale would be subject to the marginal tax rates (up to 50%). Activity from a "business" is as defined in different rulings, but remains varied and inconsistent.
4. Purchase of virtual currency with another currency - the Authority's position is: **asset exchange** means capital gains in lieu of the asset put forward, and "purchase" of a new asset in exchange. At this point we would like to state that there is a finance issue regarding the amount of taxes, because of the "movement" or asset exchange within a portfolio of virtual currency, without the client encountering "fiat" money (such as dollar, euro, NIS, etc.).
5. Sale of an asset or service provision in exchange for virtual currency - Two different revenue calculations must be performed for profit or loss

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incurred (typically considered a capital gain or loss); one with the sale of an asset or provision of service, and the second with the sale of the virtual currency.

6. Amount of proceeds in an exchange transaction in which the asset/goods has a "nominal price" - it has been established that in this case, the value of the sale of the virtual currency shall be in accordance with that nominal price. For example - if a car was purchased using Bitcoin, the amount of proceeds for that sale would be the "nominal price" (apparently the car's book value). The subject of proceeds is important, because different price quotes may be found on different trading platforms simultaneously. **Note that this provision does not apply to the "nominal price" of service providers - in which case the "fair value" of the currency must be determined.**
7. VAT considerations - an investor whose level of activity is not considered a "business" is not required to pay VAT; one with business-level activity, however, would be classified as a "financial institution". Anyone engaging in mining must register as a "proprietorship" with business activity taxed at a rate ranging from zero to the highest rate (up to 50%), as relevant. **We would like to point out that in our view, this blanket position defining mining as a business is problematic, as it could also be considered an investment - especially when the mining has an investment-like nature, such as a "pool" which manages the entire process of mining remotely, where the investor is completely uninvolved in the activity itself.**

As you can see the subject of taxation of cryptocurrency is a new one, and the Authority's positions are not straightforward, with other interpretations possible for these cases.

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The Tax Authority's first taxation decision (ruling) on cryptocurrency

The Tax Authority's first taxation decision on cryptocurrency was published this week, concerning record keeping of receipts from service provision received with decentralized coins. This decision was led by our office.

Our office provides advice and services in the cryptographic currency industry to many of our clients. Because of the nature of the activity and people involved in it, some of our clients have offered to pay for our services with decentralized coins such as Bitcoin and Ethereum.

There are quite a number of platforms today for trade and exchange of these

coins into other coins and into ordinary currency, with exchange rates varying greatly on the different platforms at any given moment. Furthermore, daily fluctuations of coin exchange rates could reach tens of percentage points between the daily maximum and minimum. Considering the fluctuation level and the difficulty in precise quantification of receipt in coins and their conversion at a particular moment to "fiat" money (legal tender such as NIS, dollar, euro), our office requested a resolution for a method of recording such intake.

The (agreed upon) taxation decision established that at the time of receipt of the coins, the company must record the number of coins actually received (for example, receipt in the amount of 1 Bitcoin) in a designated "journal for exchange transactions" as indicated in the Provisions on Bookkeeping.

In order to provide a practical solution to coin value fluctuations, **it has been established that if the company cashes out the received coins to "fiat" money within the designated period until the time of producing a tax invoice (two weeks from day of receipt), it may produce a tax invoice for the client in the gross amount actually received** at the time of cashing out, in accordance with the exchange rate of the cashing out as calculated in practice, before incurring the cost of cashing out, if such does in fact exist.

If the company does not cash out the coins received within the said period, the tax invoice shall be listed based on the "average exchange rate of the period" of the received coins. The calculation of the average exchange rate for the period shall be based on the publicized exchange rate by average number of deals in one of the central trading platforms for coins (the average of the highest and lowest exchange rates in the period).

The amount listed in the tax invoice shall be considered the "original price" of the coins for purposes of calculating profits/losses derived in the future, if such will exist. In exchange for cashing out the coins, the firm has agreed to apply to itself (but not to its clients) the Tax Authority's approach regarding classification of coins as an asset and not as currency. This means that the firm may continue to maintain that cryptocurrency is not an "asset" but rather foreign currency, until a conclusive ruling is made on the matter.

Another important ruling in the taxation decision: since decentralized coin activity is characterized by high risk for theft due to break-ins into digital wallets, it has been agreed that losses resulting from theft of coins in a particular period shall be considered an integral expense to company activity, as obtained as part of ongoing business activity.

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Coins stolen at a later time shall be expressed as a capital loss to the company.

Our office advises many different players in the crypto industry, and is well aware of the dearth of regulatory disclosures on these matters. We would therefore like to acknowledge the Tax Authority for this taxation decision.

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

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