Artzi Hiba Elmekiesse Cohen
TAX SOLUTIONS Ltd.
Tax News Alert

September 17, 2018
Tax News Alert No. 31

7 Menahem Begin st., Ramat-Gan 5268102, Israel.
16 Pal Yam Av. Haifa 3309523, Israel.
Web site: www.ahec-tax.co.il
Phone: 972-3-6134111. Fax: 972-3-6133113
Phone: 972-4-9118181. Fax: 972-4-9118188
E-mail: ahec@ahec-tax.co.il

Dear Friends and Clients
We are pleased to update you with selected Israeli tax developments for the last quarrte of 2018

Selected Issues:

- Granting options whose vesting is exit event dependent to employees on relocation
- Israeli tax ramifications of token offerings (ICOs) for foreign companies, and more...
- Delek Hungary ruling (profits available for distribution in a foreign company) – insights into international taxation

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

Tax News Alert No.31 - September 2018

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

Several weeks ago a (consentual) tax ruling was published on the subject of employee options – voiding options that at the time of vesting were dependent on an exit event and reissuing them on the "trustee capital gains" track (a track in which the benefit value is not recognized as a tax deductible expenditure by the company, and the employee is subject to capital gains tax – limited to 25% and not marginal tax of up to 47% – when the options are exercised).

The particular case in question was a private medical R&D company wholly owned by a private Dutch company. The parent company issued options to employees of the Israeli company in the "trustee capital gains" track.

The options plan asserted that the vesting of options is subject to a full change in control (an exit event). Since the position of the Tax Authority was that vesting conditional to an exit event violates the provisions of the Israel Tax Ordinance, the parent company sought to change the conditions of vesting to be time-dependent only. this was performed by canceling the original options and reissuing them under the conditions of the "trustee capital gains" track.

Without delving into all the fine details we'd like to point out that the tax decision allowed for swapping the options without payment of taxes at the time of the swap (even though Ostensibly a tax event is incurred), and

a linear mechanism would measure the value of the benefit derived from the old options, with marginal taxes paid on that at the time the new options are with marginal taxes paid on that at the time the new options are exercised.

To our understanding, the Tax Authority's position is because the exit dependent vesting mechanism does not satisfy the conditions of the "trustee capital gains" track. On the other hand, however, the acceleration mechanism (of vesting dates) activated in the case of an exit does not contradict application of the provisions of this track; this position was even adopted as part of an earlier tax decision on this matter.

So, for example, in our opinion the establishment of a particularly long vesting period with the option of acceleration in the case of an exit satisfies the capital gains track conditions, even according to the Tax Authority's approach.

Apart from the question of validity or logic of the Tax Authority's position in the context of application of the capital gains track in the case described in the tax decision, there remains a question of how to relate to the vesting period that is not time-limited (other than by a future event), in the context of division of income from exercising options in the case of a change of residency status between the grant date and the exercise date.

The Tax Authority's position (which we contest) is that the linear formula does not apply to the options based on the period the options are held as indicated in the provisions of exit tax (taxes paid when ceasing to be an Israeli resident), but rather is based on the vesting period.

Yet in the case described above, even taking into account the position of the Tax Authority, the linear formula would be applied based on the period held (equivalent under these circumstances to the vesting period), so that only the benefit associated with the period between the grant date and the residency cessation date relative to the period concluding with the company's exit would be taxed.

In our opinion, as we've already indicated, the position by which the Israeli tax liable portion may also be eligible for the capital track as established by the Ordinance is also a valid one.

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

Israeli tax ramifications of token offerings (ICOs) for foreign companies, and more...

The world of cryptocurrencies is characterized by rapid change and extreme volatility. The moods of active crypto players swing in keeping with the surprising fluctuations of coin values. Our office has met with dozens of such clients, and in recent months with quite a number of groups who are at various stages of ICOs (Initial Coin Offering) or TGEs (Token Generation Event) (hereinafter "ICO" or "token offering"). The business environment and the legal environment faced by investor groups wishing to perform an ICO is quite different from what it was as recently as a year ago, primarily due to advancements in regulation. The securities regulation agencies in Israel and throughout the world have been focusing attention in this area, and the question of whether particular tokens are defined as **utilities** or **securities**, as well as many other related legal questions, consume much time and resources of investors.

The Tax Authority issued a circular in March 2018 on the tax ramifications of ICOs. The circular addresses the tax ramifications of issuing **utility** tokens only, and clarifies the Tax Authority's position on some issues.

We won't be focusing on the general legal questions in this short alert; instead we present several areas in which tax issues should be addressed and treated in every ICO.

Country of incorporation of the offering entity

Since the attention of security regulation agencies around the world (including Israel) is focused on these issues, it would be a good idea to select a "user-friendly" country for incorporation of the entity which will be holding the offering. The entity holding the offering is typically a company, but it may also be another kind of entity; a foundation, for example, in the case of an open platform developed for public use and modification. It would be best for the entity holding the offering to be incorporated in a country with a positive general approach to cryptocurrency, and in particular to ICOs.

Countries considered "user-friendly" in this regard today are mainly Gibraltar, Switzerland, Malta, Estonia and Hong Kong. Of course you should take into account the rapid development and frequent changes of attitudes in different countries, and consult with reputable local professional advisors, getting up-to-date information before choosing a country of incorporation.

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

www.ahec-tax.co.il

Structural changes and preparation for an offering In some cases, carrying out token offerings in "user-friendly" countries of incorporation requires transfer of part or all crypto activity to the offering entity after incorporation, including intellectual property and other rights developed prior to the ICO. It's important to consider the tax ramifications that such changes may incur in Israel or abroad, and issues such as control and management of that company, various anti-avoidance rules, transfer pricing principles, etc.

Sometimes, in cases where the company or concern is engaged in ordinary business activity, it may be necessary to transfer the real activity of the company to the foreign issuing entity, or to give it rights to use the transferred assets, typically in cases where in parallel to developing a crypto strategy and financial framework for it, the offering company plans to open up independent real activity based to some extent on its previous activity. In these cases too, it is important to consider the potential tax aspects indicated above.

Tax ramifications of token offering for token recipients

Careful attention should be paid to the tax ramifications on employees who receive tokens as part of the offering, as well as on service providers in Israel and abroad and the offering initiators who may also receive tokens, often a significantly large number of them. Issues of quantification and timing of expenditure deductibility at the company level need also be addressed. The Israel Income Tax circular (2018/7) addresses these issues as well, and to some degree allows for employees to defer tax events to the exercise date of the tokens.

Test for eligibility for benefits due to Encouragement of Capital Investment Law (ECIL)

Benefits from ECIL in Israel may be granted to an offering company on revenues derived from ICO "money", at the time of their recognition in accordance with established rules, as long as it satisfies conditions established by law. Thus, for example, if revenues from sale of a product that a company develops is eligible to benefit from ECIL, it could also benefit from ECIL in the case where the consideration of the offering reflects an obligation to provide a said product. In any event, there can be various and sundry cases regarding revenues and expenditures of the offering company, including R&D, thus applicability of ECIL to each case should be carefully examined.

VAT considerations

In most cases, events related to token offerings classified as utility tokens –

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

whether issued directly by an Israeli company or if it undertakes the obligations of the offering entity towards the token owners in parallel with receiving the consideration of the offering – incur VAT liabilities.

In this context it would be necessary to determine whether the company's obligation to the token holders is a service or a product; if the consideration is received in regular ("fiat") currency or virtual coins such as Bitcoin or Ethereum; what the residency status of the coin holder is at the time of service or product consumption; etc. These are all factors in the timing and quantification of tax events.

In the past two years our office has been actively involved in cryptocurrency issues and have accumulated a wealth of knowledge and experience in the area. We advise crypto investors, including conducting voluntary disclosure procedures, and we advise and support entities involved in token offerings (ICOs).

Delek Hungary ruling (profits available for distribution in a foreign company) - insights into international taxation

The Delek Hungary court ruling has recently been published. The ruling (and the analysis it raises) is quite fascinating, but without going into the details of all issues raised, we feel it's important to mention here that ultimately, the court preferred to take the perspective of the objective at the basis of the various legal provisions rather than adhering to the letter of the law. In particular the court focused on the principals behind the provisions of the Income Tax Ordinance on "profits available for distribution" (accumulated profits of a sold Israeli company at the time of its sale, on which there is a tax liability on the part of the seller as if they were distributed to him as dividends on the eve of the sale), on "underlying foreign tax credit" (a tax credit upon corporate tax that a foreign company paid, that an Israeli company holding that foreign company at the time of dividend distribution has a right to) and the combination of the two.

And so, basing it on the principles of "two stage taxation", it established that given the circumstances of the case, **the desired outcome would be for the dividend distribution before sale of a foreign subsidiary to be equivalent as far as taxes are concerned to the sale of a company including its not-yet-distributed surplus**, both in order to create neutrality for business decision-making and in order to maintain a similar effective tax burden.

From the point of view of the appellant, there was no tax equivalency between the two alternatives in this particular case due to the fact that the dividend

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

have placed an additional tax burden on him – the amount withheld abroad at source at the time of dividend distribution, but why ruin the party? As a result of the ruling, an Israeli company could have its cake and eat it too – it could receive an underlying tax credit and also avoid withholding tax upon dividend distribution.

Although **you should not conclude from this ruling that taxation of a portion of the capital gains at the time of sale of a subsidiary is always equivalent to the tax on dividends it distributes, this idea - which is not unreasonable given the ruling - may have other international tax ramifications** one way or the other. Here are several examples and some questions to think about:

1. A foreign company selling an Israeli subsidiary (on the assumption that it is not tax exempt at the time of sale), is in fact eligible to benefit from the provisions of the laws of "profits available for distribution", such that the sum of accumulated profit may be viewed as if it had been distributed as dividends. The principle of equivalency applied in the ruling reinforces our conclusion by which the tax rate on a portion of the capital gains equal to the profits available for distribution, must be equal to withholding rate on dividends as per the relevant tax treaty, even if according to the Tax Ordinance it is considered capital gains!!!
2. In addition to the aforementioned, and on the flip side – could the Tax Authority claim that at the time of sale of an Israeli company's stocks by a foreign company which is tax exempt (whether by virtue of Israel Tax Ordinance provisions or by virtue of a tax treaty) that the "profits available for distribution" component which is part of the capital gains must still be taxable (rather than granting an exemption in lieu of it) at the same withholding rate that applies to the dividends as per the provisions of the treaty? And this would be for the sake of carrying out tax equivalency...
   Although it would be tempting (in the eyes of the observer) to do so, we would like to add that as a rule, provisions of the tax treaty (in our case – withholding taxes on dividends) are not intended to create a tax burden in a place where provisions of the internal law do not allow it.
3. Could we stretch our imagination so far as to claim that implementing tax provisions that apply to capital gains are relevant even in the case of dividends distributed in practice as part of a comprehensive sale deal? For example:
   - A foreign company received dividends from an Israeli subsidiary a moment before selling it – can it claim that the sum of the dividends should be viewed as a part of the

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

- period, and is forced to distribute the available surplus as dividend prior to sale (for example, if the purchaser does not wish to acquire cash). Could he claim that the dividend is an equivalent substitute to capital gains (the exemption on his portion on a linear basis) that would have been higher had the surplus not been distributed as dividends? This is especially so in the case where the distribution was forced upon him.
- In order to balance things out, could the Tax Authority claim that anyone who ceased being an Israeli resident and after a period of time received dividends from a foreign company that had been under his ownership prior to the cessation of residency before its sale or liquidation, must be taxed? After all, if that same individual had sold the company (with the accumulated surplus) he would have had a tax liability on that portion of capital gains in accordance with the provisions of the exit tax.

Many more such examples exist.

We can safely assume that some of the examples raised above deviate from the interpretive boundaries brought down in the ruling, and it is quite reasonable that the Tax Authority objects to some of them, since the ruling relates only to the combination of the provisions of profits available for distribution and the possibility of obtaining underlying tax credit at the actual time of dividend distribution, for the purpose of avoiding unreasonable effective taxes.

Thus, in the event of the alternative between dividend vs. capital gains (before or after the relevant tax event), make sure to carefully examine how the ruling would apply in the particular case.

Another interesting point in the ruling is the term "tax", defined in the Tax Ordinance as "... either personal income tax or corporate income tax imposed under this Ordinance (hereafter known as "Israeli Tax"). According to this, logical language dictates that any time the Ordinance refers to the term "tax" it is referring to Israeli tax. Yet in the ruling the court preferred the intentional interpretation and not the literal one, as we described above, and this interpretation may require viewing taxes paid abroad also as "Israeli tax". This paved the way for defining foreign corporate profits as profits available for distribution for purposes of carrying out provisions of the clause, and in the words of the ruling itself: "... to include in the term 'tax' any tax **taken into account** as part of the overall taxation method... Therefore, foreign taxes, too, although they are not 'imposed' by the Ordinance

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.

but are 'imported' into the Israeli taxation method by means of granting an exemption at the time of dividend distribution, is considered 'tax' for this purpose, and should be seen as such".

The judge mentions in the ruling that "the legislator is not to be held as one who has created a masterpiece in all that relates to Formulation of tax provisions, and especially in international taxation"

We can sum this up as follows: First, **we cannot establish categorically that every use of the term "tax" in the Ordinance includes foreign taxes. But neither should we conclude the opposite - that use of the term "tax" always excludes foreign taxes.** And so, the question of whether foreign taxes must be taken into account as part of the definition of the term "tax" must be examined based on context and on the purpose of the clause under consideration. **Many examples could be found on the ramifications that this ruling could have on the definition of the term "tax" in the Ordinance, and in relevant cases it would be advisable to consult with experts to determine whether foreign taxes can be viewed as "Israeli taxes". Each case, of course, must be addressed individually.**

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

CPA. Ran Artzi, Managing Partner (artzi@ahec-tax.co.il)
Advocate and CPA. Hagi Elmekiesse (hagi@ahec-tax.co.il)
Advocate and CPA. Gadi Alimi (alimi@ahec-tax.co.il)
CPA. (LLB) Eyal Sando (sando@ahec-tax.co.il)
CPA. Yossi Shalom (yossi@ahec-tax.co.il)
Advocate. Danny Fink (dan@ahec-tax.co.il)

The content of this Tax News Alert should not be regarded as a tax opinion, an examination of the relevant laws, or as professional consultation, but only as a general and a high- level briefing of selected issues.

Any implementation, which is based on the information provided herein, should only be performed after obtaining professional and specific consultation.