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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 2019

Selected Issues:

- Completing the revolution: taxation on income generated abroad by a foreign resident.
- Report by the Security Authority's Committee in Connection with the Issuance of Crypto-Currencies and the Tax Implications.
- The way to an exemption on the sale of traded securities in the hands of a foreign resident

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.

Completing the revolution: taxation on income generated abroad by a foreign resident

A tax ruling has been published recently, which deals with the taxation of income from the exercise of options by a returning resident. **"Spoiler" - the Tax Authority has determined that income from options that have vested outside of Israel when the individual was a foreign resident is taxable in Israel,** and thus it has retracted its position in previous tax rulings. This tax ruling constitutes a continuation of a previous tax ruling regarding the taxation of a salaried employee, in which too it was determined that income (salary differences and bonuses), which has been generated by the individual abroad at the time that he was a foreign resident, will be taxable in Israel, if it has been received by him after he returned to be a resident of Israel (on a cash basis).

A brief description of the case:

The case concerns an individual who was a foreign resident for about five and a half years (between the years 2011 and 2016), in the course of which he worked in an American company and received options for shares in the Company, which vest over a particular period of time. After he returned to Israel, the individual continued to work in an Israeli company which belongs to the same group.

The question that stands at the foundation of the ruling:

Is an individual chargeable to taxation in

Israel in income deriving from the exercise of options (and the sale of the shares thereunder), even if they vested in a period in which he was a foreign resident and only exercised when he was a resident of Israel?

The tax ruling and its implications:

The Tax Authority's position so far as regards the taxation of options in the hands of employees as a result of a change in residency, was that at the time of the exercise, the part of the profit that has been produced in Israel and abroad has to be calculated, in accordance with the vesting period, and the part that was produced abroad, when the individual was a foreign resident was not taxed in Israel. This was determined, for example, in previous tax rulings.

In the tax ruling under discussion, it was determined explicitly that the new position, which has been determined, annuls and replaces the position that had been adopted in the tax decisions that are mentioned above. What has led the Tax Authority to change its position? For the provisions of the law have not changed and no binding case law has been determined in the Courts. Has the Tax Authority been mistaken for more than a decade? It is not reasonable. It would seem that the change in the position derives simply from the interest of collecting more tax from assessees. In respect of the timing of the exercise, it was determined in the decision that this will be at the time of the sale of the shares deriving from the exercise of the option, and not at the time of the conversion into shares, which is in accordance with the mechanism that is set in the Israeli Tax Ordinance. This determination contradicts what is stated in all of the previous tax rulings, and it was appropriate to determine that in this connection too, the current tax ruling annuls and replaces previous rulings.

By the way, it would appear that the explanatory words in the OECD's model treaty specifically support the determination of the time of the exercise on the basis of the conversion of the option into share (which also allows countries to determine otherwise). How may the determination of the timing of the exercise be of influence in other cases?

If for example, the employee exercises the option into share before he returns to Israel, then in such a case if the timing of the exercise is at the time of the conversion of the share, then all of the profit that is attributed to income from labor will not be chargeable in Israel, and the capital gain on the sale of the share afterwards may be exempt from tax in Israel, insofar as may be relevant. The current tax ruling brings up absurd scenarios.

Thus for example, in accordance with

the tax ruling, an individual who holds options that have vested in fill and which have been converted into prior to his return to Israel, the profit from the sale of the share, insofar as it has been sold after his return to Israel, will still be considered as income from labor that will be chargeable with taxation in Israel, even if it is clear that at the time of the return, the individual has a capital asset and it makes no difference if this has come into his hands under the force of a labor relationship or whether it is property that he has paid for with his own private money.

So what do we do?

Consideration needs to be given to the possibilities for converting the options into shares before returning and even of selling the shares (in case the Tax Authority may seek to tax the profit from the sale if it is executed after returning). Insofar as the individual may be required to pay a higher rate of tax on the conversion of the option and/or on the sale of the share in a foreign country, consideration should be given to determining residency in a third country as "an intermediary station", in which it will be possible to sell the rights, prior to the return to Israel. There may be additional creative solutions.

In any event, in our opinion, it will be possible to defend a position that contradicts the position taken by the Tax Authority, which is reflected in the tax ruling that is under discussion, pursuant to which the reporting basis that applies to an individual (a cash basis) is not supposed to change the substantive taxation that applies, but rather it only determines the timing, as has been determined in case law, for example on the subject of other sections that are quantifying and timing sections and not original sections that are binding in and of themselves.

And one final question – where is it determined that an employee and a services provider are required to report their income on a cash basis?

Report by the Security Authority's Committee in Connection with the Issuance of Crypto-Currencies and the Tax Implications

In March 2019, the final report by the Security Authority – The Committee for the Arrangement of the Issuance of Distributed Ledger Technology Based Crypto-currencies to the public. The final report was published after the publishing of a very detailed interim report, which was presented to the public in March 2018. The Committee's main role was to consider the application of the Securities Law to the issuance of crypto-currencies.

A year has passed since the publication of the interim report, and very significant changes have occurred in the crypto industry, including – the collapse of the market value of the currencies and of the volume of trading, a significant decrease in ICO recruitment, and a reduction in the field of STO recruitments. A short explanation of the terms: The term ICO (Initial Coin Offering) means the process of issuing tokens. The term STO (Security Token Offering) means the issuance of a token that has characteristics of a security (for example – a token that affords rights in assets or which affords part of the profits of a project and etc.).

The final report details the main factors that have molded the principal changes in the past year, including the issue of Regulation. Many countries across the globe, headed by the United States presented a tough position regarding the field of crypto issues – a position pursuant to which most of the issues of tokens (ICOs) constitute the issuance of a "security". The significance of the application of the Securities Law to the issuing of tokens was especially hard for parts of the industry who believed that the existing regulations are not appropriate and do not apply to recruitments of funds in this manner. The result of the toughening of the regulations globally regarding this field has been the undertaking of defensive activity, such as the imposition of self-regulations – an approach to qualified investors alone (those who can be offered securities without a prospectus), taking note of the prohibition of money-laundering laws and the examination of the investors' source of financing and the execution of know your customer (KYC) processes.

The main recommendations in the final report are the application of a special disclosure regime for offerings of tokens within the framework of the Securities Law, the enabling of regulatory reliefs and the creation of the conditions for use within the framework of a "regulatory sandbox", consideration of the possibility of arranging a special platform for

trading in crypto assets and consideration of a "crowd financing" model for ventures in the field. Our firm has accompanied and is accompanying a number of groups that were in various stages of offerings by issuing tokens – and tax questions arose in all of those groups, as well as regulatory issues. In our experience, most of the ventures chose to execute the offering by means of the establishment of a foreign corporation that is located in a country in which the regulations are "friendly" to the crypto industry (such as Gibraltar and Switzerland), and this is inter alia, with the objective of meeting the regulatory requirements. It is clear that the issue of incorporation is only one of the numerous other regulatory aspects that need to be examined, such as the classification of the tokens, who is permitted to offer them, consultancy and the holding of tokens, banking, prohibition of money laundering laws and so on.

In theexamination of the tax aspects, our recommendation is to make an approach for a tax ruling from the Tax Authority within the framework of the offering of tokens, which is in light of the publication of a professional circular by the Authority (Income Tax Circular – ICO - The offering of "Digital Tokens", for the provision of services and/or products in development (Utility Tokens), in order to obtain certainty regarding the recognition of the income by the issuing company as a result of the offering of the tokens, the timing of the recognition of that income and the amount thereof, tax aspects regarding employees and providers of services who receive tokens, VAT implications and an attempt to understand the tax implications in the hands of the entrepreneurs who will hold tokens

We would clarify that the said circular applies to the issuance of utility type tokens, to differentiate from security type tokens. In respect of the latter (which below to STO offerings), the Tax Authority is currently working on the publication of a draft circular in which it will express its opinion.

The way to an exemption on the sale of traded securities in the hands of a foreign resident

A few weeks ago, the Tax Authority published a new form, the title of which is "Annual report for a foreign resident company that has an exempt capital gain from the sale of securities that are traded on a Stock Exchange in Israel". Amazingly, the form was removed one day later and as of the present time, it is not to be found on the Authority's website. Prima facie, this is a procedural matter, however, its very distribution (which may come back again), and its contents, raise a number of questions.

<u>The legislative framework</u>

The Income Tax Ordinance exempts a foreign resident from tax on capital

gains from the sale of securities that are traded on the Stock Exchange in Israel. However, the tax benefits or the exemptions for a for a foreign resident company are denied if 25% or more of the of control in it are held by Israeli residents. In such a case, it is possible that the foreign company will be entitled to an under the provisions of the relevant tax treaty.

procedural level, a foreign company that has income in Israel is required to submit an annual report in Israel, as compared with a parallel provision regarding a foreign individual, who is only required to submit an annual report if he has taxable income in Israel. There is a provision in the "Exemption from the submission of a report" Regulations, which exempts a foreign resident from the submission of an annual report in certain circumstances, but which does not include capital gains even if they are tax exempt.

In light of the aforesaid, theoretically, a foreign resident company, which has generated capital gains from the sale of securities that are listed for trading in Israel, even where they are exempt from taxation, requires the submission of an annual report. This theoretical duty also exists in respect of an investment account that is managed in the foreign company's country of residence

a local broker. However, to the best of our knowledge, **the practice that is customary is that such foreign companies were simply not submitting reports in Israel if all of their income is exempt, as aforesaid, and it would have been appropriate to amend the regulations that afford the exemption from the submission of a report to a foreign resident under certain conditions, such that a clear exemption for foreign residents would be made available on the sale of securities that are listed on the Stock Exchange as well, instead of providing an alternative procedure for submitting the reports.**

The change

Apparently, the said form constitutes an abbreviated report for reporting on exempt income, instead of a full annual report, which is a "welcome" relief for investors. However, in relation to the current practice, **the publication of the form constitutes a call for foreign companies that invest in Israel to submit reports** (albeit within the framework of that same abbreviated report). The form is not submitted to the Assessing Officer but rather to the Capital Market Department and to the Professional Division, and it includes the details of the foreign company, the details of the securities portfolio accounts and certain declarations of the foreign corporation.

Declarations

The foreign company is required to declare, inter alia, that:

- It is a foreign resident in accordance with the definition in the Israeli Tax Ordinance, i.e., the absence of "management and control" in Israel;
- It does not have a permanent presence in Israel (without a clear definition of what a permanent presence means);
- **There is no holding in or indirectly), by Israeli residents at a rate of 25% or more**. In effect the Company is required to declare that the section in the Ordinance on the conditions for the granting of reliefs to a foreign resident applies to the case in hand, however, for this purpose it needs to clarify who the ultimate shareholders are and this may not be a simple matter in certain cases.
- **The exempt income is reported in the foreign corporation's country of residence!** In effect, the Tax Authority in Israel is implementing the directives issued by the Bank of Israel to banking institutions in Israel, which are required, in accordance with those directives, to clarify that a foreign resident, who holds an account in that is maintained in that bank, is in compliance with the tax laws in its country of residence. We would mention in this connection that **there is no tax implication in Israel for the absence of reporting abroad** (and sometimes no reporting at all is required abroad in accordance with the tax laws in that country), in other words, **the foreign company will still be entitled to an exemption under the provisions of the Ordinance!** And the question needs to be asked – why is such a declaration required? Is it for the purpose of an initiated transfer of the information to the other country? For this is not required in light of the existence of a mechanism for the transfer of information automatically regarding bank accounts between most countries (CRS).

The content of the declarations and the fact that this is a form that is recorded in the Hebrew language alone – in contrast to other forms, which are intended for foreign residents and which are (also) written in English – may provide a hint that the Tax Authority is trying to identify foreign companies that are held by Israelis indirectly for considerations relating to the avoidance of taxation. If this is indeed the intention, it will be possible to instruct the banking institution in Israel in which the foreign company's investment account is maintained to sign it on such a declaration (to the best of our knowledge, in any event foreign residents are required to sign on certain similar declarations to the

bank), **and to report to the Tax Authority on those cases that have been defined as being reportable,** instead of placing the procedural burden on all foreign all foreign **investors, and it is possible that some of those investors will simply choose not to invest in Israel** in order not to get into the net of reporting to the Israeli Tax Authority.

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

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