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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 Second quarter of 2019

Selected Issues:

- A trustee in a relocation - Issues in the severing of the tax residency of a trust.
- Capital gains - The Bitcoin is deemed to be "an asset" for income tax purposes.
- Options for an employee in "Cost +" companies - is this the end of the chapter?

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

Tax News Alert No.34 – July 2019

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.

A trustee in a relocation – Issues in the severing of the tax residency of a trust

The chapter on trusts in the Israeli Tax Ordinance affords the status of a taxpayer for tax purposes to a trust (including a registration number, a managed file in an assessing office etcetera), even though the trust itself is not an independent legal entity but is rather a legal arrangement, generally between a settlor and a trustee.

Part of that same status is its residency status for tax purposes. The provisions of the Israeli Tax Ordinance determine in relation to each of the types of trusts when the trust is to be viewed as an Israeli resident individual ("An Israeli trust") and when it is to be viewed as a foreign resident individual ("A foreign trust"). Thus for example, in connection with an "Israeli residents' trust", it is determined that "An Israeli Residents' Trust will be considered to be resident in Israel, and the income of the trust will be viewed as the income of an individual who is a resident in Israel and the trustee's assets as the assets of an individual who is a resident of Israel". In connection with a "Foreign Residents' Trust", for example, it is determined that "A Foreign Residents' Trust" will be considered to be a foreign resident and the trustee's assets will be viewed as assets that are held by a foreign resident and the trustee's income as income of a foreign resident individual".

A trust may change its residency where there is a change in the particular circumstances, such as the addition of a beneficiary, a change in the revocability

terms, and of course where there is a change in the residency of a settlor or a beneficiary, as the case may be. Thus, for example, in a trust pursuant to a will (a "Will Trust") in which there is a beneficiary that is resident of Israel who becomes a foreign resident, the trust will change its classification (and accordingly its residency) from an "Israeli Will Trust" to a "Foreign Will Trust", at the time at which it is determined that the exit tax provisions will apply, mutatis mutandis.

A change in the residency of individuals (primarily in the direction of leaving Israel) is a complex issue, which has been discussed every now and again within the context of various judgments, tax decisions and other professional directives, as well as in numerous discussions that have been held between representatives and the tax authorities.

The Tax Authority is contemplating the issue at the present time, with the intention of changing the tax residency rules in respect of an individual, such that instead of the substantive test of "center of life", it will include technical and measurable tests (primarily the index of the days of presence), which will constitute absolute (irrefutable) assumptions. This change will lead to certainty regarding the timing of the severance of the tax residency for the purposes of the provisions of the Ordinance (internal law) on the one hand and on the other hand it will expand the array of cases in which the individual will be deemed to be an Israeli resident in accordance with the provisions of the Ordinance but as a foreign resident in accordance with the provisions of a relevant treaty country. These cases may include circumstances in which, for example, the individual is a resident in a foreign country but visits Israel a lot for whatever reason.

The question arises – what is the law in respect of a trust in which the settlor or the beneficiary has changed their residency in a manner and in circumstances, which are also supposed to change the trust's residency (see above), however the severance of residency is done solely in accordance with a treaty and not in accordance with the provisions of the Ordinance?

There is no clear answer to this. Our position is that in such a case the residency of the trust is to be changed from an Israeli trust to a foreign trust. This position is based on the assumption that the provisions of the trusts chapter were intended to visualize a legal situation that would exist were the assets are held by the settlor or the beneficiary and not by the trustee. In such case, the income of someone who has severed its residency in accordance with a treaty, wouldn't be taxed.

The Tax Authority may claim, on the other hand, that the "tiebreaker" conditions that are included in the tax treaty relate solely to the place of residence of individuals and not to entities that are not individuals, including trusts. Moreover, in treaties in which trusts are explicitly mentioned, there is no clear solution, since sometimes a trust is simply included in the term "person" in a general and ambiguous manner (for example – in the treaty with Canada), or it is determined in a treaty (including in a protocol to a treaty) that in the case of double residency, the matter will be decided by way of mutual agreement (for example in the treaties with Austria, Panama and Malta).

As mentioned above, because of the expectation that there will be a multitude of situations in which the severance has been made in accordance with a treaty alone, **this issue is expected to have an honorable place in discussions that are held with the tax authority on the subject.**

Capital gains – The Bitcoin is deemed to be "an asset" for income tax purposes

Recently (in May 2019), a judgment was handed down, which the crypto industry had been anticipating (but not the result that was determined in it), pursuant to which a Bitcoin is deemed to be "an asset" and not "a currency".

The significance of the judgment is that it will make it more difficult for crypto investors to take a position pursuant to which their investment is deemed to be in "a currency" with the increase in value being deemed to be "exchange differences", which are exempt from tax in Israel (pursuant to the provisions of the Israeli Tax Ordinance, exchange differences are exempt from tax in the hands of an individual). In accordance with the Judgment, a Bitcoin is deemed to be "an asset" and accordingly Part E of the Ordinance will apply to it and it will be taxed as a capital gain, without offsetting the increase in "the currency exchange rate" from the capital gain.

Within the context of the judgment, the Judge ruled out one by one the numerous claims made by the investor, that the Bitcoin should be classified as a "currency", including the claim that it is "legal tender", claims that in accordance with accounting principles and from an economic perspective, the Bitcoin should be recognized as "a currency" and alternative claims on the matter of "a security", which is linked to the price of the Bitcoin.

An interesting claim is the claim of retroactivity - the taxation of gains on Bitcoins that have arisen from the time of their sale in 2013, where a draft

position was only published by the Taxes Authority in 2017. This position was also not accepted by the Judge.

The Judge emphasized the physical aspect that "a regular currency" has as compared with the Bitcoin currency, which lack any physical aspect, since it is only recorded digitally, and the fact that a very considerable portion of "the regular currencies" are also effectively registered digitally (most of the "money" that exists in circulation is not cash money but rather is registered digitally in banks), was of no assistance.

We would mention that this judgment does not constitute the most common and problematic case for crypto investors. **We have met hundreds of crypto investors in our offices, and for most of them the main problem derives from the fact that they have exchanged one crypto currency with another and as a result of this they have effectively exchanged one "asset" for another "asset" and as a result of this they have generated a capital gain at the time of the increase in the value of the asset that they have exchanged (or "sold"), primarily in the year 2017.**

<u>Ancillary results and additional insights</u>

From what was stated by the Judge, which reflects the judicial norm in the tax laws, only real enrichment should be taxes, and taking the digital currencies market into account, it would be appropriate to enable the deferral of the tax until the final meeting with "the money", and we would like to illustrate this point:

Where a client has executed exchange transactions between crypto currencies, where their value increased very sharply during the course of 2017, it should be interpreted that so long as they have not "cashed out" the "enrichment" into "real money"- it should not be taxed. We are aware of many cases in which the value of the crypto portfolios following the collapse of the value of the currencies in 2018 their value has reached an amount that is even lower than the amount of the tax! We hope that when cases like these are clarified in the Court, the Judge will find the legal and the economic way to rule that these events should not be taxed - but rather this should be done at the time and in accordance with the "cash" value in "real currency".

In any event and under the assumption that the Tax Authority is aware of the colossal volume of the exchanges that have been performed in the crypto currencies, and with the collapse in the value of the various currencies, in order not to tarnish this large "harmed" population (who without any great joy will submit reports on a gain from the exchanges, whereas in practice they have only realized losses) as criminal, it would be appropriate to make a change

in the legislation, which would enable the continuity of the taxation, whilst exempting an exchange from currency to currency from taxation, with taxation only at the end of the day. There is a not inconsiderable public made up of people who hold these currencies and who have been waiting to make a voluntary disclosure process. These people too need such a solution.

In addition, the Court's determination will enable the recognition of capital losses for all of those people who sold their coins after the fall in the price of the Bitcoin and other crypto currencies.

And finally - since it has been determined that the Bitcoin is not a currency but rather an asset, it is possible that the Law for the Reduction in the Use of Cash (a law that was legislated recently in Israel with the objective of reducing the use of cash, which is not traceable and not identifiable), will specifically not apply to payment and purchase transactions in crypto currencies. The legislator has to take this situation into consideration.

Options for an employee in "Cost +" companies - is this the end of the chapter?

In April 2018 a (unanimous) ruling was handed down by the Supreme Court on two different appeals, which deal, inter alia, with the application of the section that deals with transfer pricing, in respect of the question of whether the cost of the allocation of the options to employees of a subsidiary company should be included as part of the cost basis for determining the market price of an international cost+ type transaction between related parties.

Approach to the representatives

The Tax Authority's position, as presented in the ruling, has also been included as "a position that requires reporting", and it has been determined in it that income is also to be included under the Cost+ method, in respect of options based costs, and also in respect of expenses that have been adjusted in the statement of adjustment for tax purposes, or which have not been required in the financial reporting but which had to be required in accordance with generally accepted accounting principles.

In December 2018, the Tax Authority published an circular to the representatives, pursuant to which, following the ruling by the Supreme Court that "The cost of the allocation of options must be included in the cost basis for the purpose of calculating the profit for tax purposes, "**it is expected of companies that they correct their reports** in accordance with the ruling and the position adopted by the Tax Authority and if they do not do so, assessment processes will be instituted **within the context of which a higher "transaction price"** than the reported transaction price **may be determined** (in

accordance with the median inter-quarterly range), and in certain cases, deficit fines may even be imposed.

Is every company required to correct reports "automatically" or is it still required to consider each case individually?

We would mention that in both of the rulings, the cases concerned an Israeli subsidiary that provides research and development services to an American parent company on the basis of the Cost+ method. The appellants granted options to their employees for the purchase of shares in the parent company on the preferential "capital gain path" in accordance with Section 102 of the Israeli Tax Ordinance. It was determined in the ruling that "…the very fact of the inclusion of the cost of the allocation of the options in the cost basis, does not lead to the assessing officer being entitled automatically to interfere in the parties' agreements, as expressed in the report regarding the transactions. This interference is only possible in a case in which the assessee has not met the burden of persuasion by showing that the transaction price, which includes the value of the options accords with the price that is acceptable in the market for similar transactions…" and also, in relation to the case in question "the theory that is presented by the assessees, pursuant to which the cost of the allocation of the options should not be included in the cost basis, within the context of the transactions in question of a cost plus type - does not fit with investigations of the conditions in the market that have been submitted on their behalf. This is because the profitability rates of the comparative subsidiary companies, in accordance with which the assessees sought to extrapolate the value for the case before us, take the value of the options into account".

We conclude that **the inclusion of the cost of the options in inter-company services transactions does not lie within the bounds of "something that is unavoidable" and that the fact of their inclusion or of the avoidance of their inclusion is dependent upon the circumstances of the case,** the inter-company agreements and the transfer pricing method that is implemented.

A demand to correct the reports raises a number of questions: Is it required to correct reports if the transaction price that has been set still lies within the range of prices that would have been set whilst implementing the Tax Authority's position? Within the framework of the correction of the reports is it only required to update the cost basis (which is to include the cost of the options as aforesaid), or is it possible to consider electing for a different pricing method that is still implementable in the circumstances in hand, if it provides a better reflection of the inter-company economic model?

In summary, the inter-company services agreements should be

checked thoroughly and if the cost of the options has not been included in an inter-companies services agreement, proper consideration should be given as to whether to correct the previous tax reports. In any event, we would recommend receiving professional advice before taking any action.

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

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