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Tax Residency of Foreign Companies - The "Control and Management" Test

Recently, following the judgments in the Niagu, Yanko Weiss and Shai Zamarot cases, the Israeli Tax Authority (ITA) further clarified its position as to when a foreign company is considered to be "controlled and managed" from Israel and thus considered an Israeli tax resident.

Background - The "Control and Management" Test

Under the Israeli Tax Ordinance (ITO), a corporate entity is regarded as an Israeli tax resident if: (i) it was incorporated in Israel; or (ii) the control and management of its business are performed in Israel (known as the "control and management" test). While the question of incorporation is a factual question that is simple to determine, the ITO neither defines nor provides any guidance as to what would constitute "control and management" and Israeli courts have interpreted it based on the specific circumstances of the matter brought before them. In the past, upon implementation of the test, courts examined, inter alia, the legal and formal ownership, the location of shareholders' meetings, and primarily, the location of meetings of the board of directors of the company. Today, as part of the general trend in law to place an emphasis on substance as opposed to form, the tendency is to examine the business – practical aspect of the "control and management". For this purpose, an examination is conducted as to where and by whom the effective ability is held, to determine the company's strategy and business policy and to instruct the subordinate ranks as to how the aforesaid policy and strategy should be implemented.

Income Tax Circular No. 4/2002

In 2002, the ITA published Circular 4/2002 (Circular) on the subject of "control and management" that sets the criteria for the implementation of the test. Although circulars published by the ITA are not binding, they provide a "safe harbor" for taxpayers who follow them. The Circular explains that "control and management" is exercised as a matter of fact, which must be examined based on the specific set of circumstances. Furthermore, the Circular provides guiding criteria for the application of the test, including, inter alia: where the decisions are made at the level of the business policy and the strategic management, the authorized entity which actually controls and manages the day-

to-day and current management, the organ of the company that is granted extensive discretion to reach decisions, etc. The Circular emphasizes that in the past, great weight was given to the physical location of the convening of the board of directors, however, at the present time, given the current progress and the ever-increasing sophistication of means of communication and transport, the actual physical location of the convening of the board of directors is deemed to be an insufficient and out-of-date parameter.

Addendum No. 1 to Income Tax Circular No. 4/2002

In August 2016, the ITA published an addendum to the Circular (Addendum). The Addendum was published following the said judgments, in which the “control and management” test was reconsidered. This came about following a period of many years in which no judgments were published concerning the matter. The Addendum continues with the direction that was established in the original Circular, emphasizing substance rather than form and provides more details as to the various criteria. The Addendum states that a formal and technical examination is insufficient, and it is necessary to conduct a material and comprehensive examination for the purpose of determining the question of the existence of “control and management”. As indicated by the Addendum, it is necessary to determine the decision-making party (the driving force) that navigates the company’s operations and actually makes the material decisions in the matters of the Company’s business policy, and the location thereof.

The Addendum also instructs that protocols are to be requested for the purpose of examining whether in fact the board meetings were held or whether a “rubber stamp” was merely used for the decisions of another party. Additionally, it is necessary to consider the experience of the directors, their understanding of the activities of the company, whether they are employed by a professional management company that provides services to additional companies, what their compensation is and who determines it, whether they are fluent in the language in which the company conducts its activities, etc.

Following the new judgments and the Addendum, we notice that in practice, the Israeli Tax Authority has strengthened its examination of the matter of “control and management” of foreign companies held by Israeli shareholders, and in many cases claims that these companies should be viewed as Israeli tax residents since their control and management is carried out from Israel.

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