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Israeli CFC Tax Regime on Israeli Investments Abroad

Recently, the Israel District Court published a precedential ruling in the case of **Rosebud V. Assessor Officer for Large Enterprises,** in which it addresses the interpretation of the provisions of section 75B of the Israeli Tax Ordinance **(ITO)**, pertaining to a Controlled Foreign Company **(CFC)**. This ruling may have a significant implication on the activity of Israeli investors outside of Israel through foreign companies under their control, particularly on foreign companies investing in real estate outside of Israel.

In January 2003, Amendment No. 132 to the ITO, which introduced a comprehensive reform in the Israeli tax law, came into effect, implementing, among others, the personal taxation method in lieu of the territorial taxation method. According to the personal taxation method, an Israeli resident for tax purposes is taxed in Israel on his worldwide income. In addition, as part of Amendment 132, the legislator enacted several anti-avoidance provisions intended to prevent tax avoidance by establishing foreign companies. The main anti-avoidance directive in this context is the application of the CFC regime, anchored in section 75B of the ITO. This section provides that a resident of Israel who is a controlling shareholder of a CFC which has passive income that has not been distributed as dividend, shall be deemed to have been the recipient of a "deemed dividend" in the amount that reflects the proportionate share of such profits.

A CFC is a private foreign tax resident company, controlled by Israeli tax residents, which most of its revenues or profits is derived from passive income, whereby the tax rate in the foreign country does not exceed 15%. Passive income includes interest, linkage differentials, dividends, royalties, rent and proceeds from the sale of an asset, provided that such income does not qualify as business income.

In the case at hand, Rosebud (an Israeli subsidiary of a public company traded in the Tel-Aviv Stock Exchange) held a Dutch company that in turn held several companies in Luxemburg. The latter held several foreign companies, each of which separately held real estate assets. This holding structure, in which each company holds only one real estate asset, is highly common in the real estate sector. It has many business advantages, which are not necessarily tax related, including: (i) limitation of liability; (ii) financing benefits; (iii) the possibility of selling assets separately - either directly or through the sale of shares. In this case, both properties and shares were sold, and Rosebud argued that the provisions of Section 75B of the ITO do not apply, since the sales should be regarded as business sales, rather than passive tax events that trigger the CFC regime.

The tax assessor argued that the sale of a single asset or shares of a company holding a single asset creates capital gain that is passive income, and thus the CFC regime should apply. On the other hand, Rosebud argued that the sales were part of the overall activity of the group of companies, which includes the development, management, leasing and realization of real estate properties, which is to be considered business activity. Accordingly, Rosebud argued that the sales do not trigger the CFC regime.

While emphasizing the preference of the economic substance over form of the transactions, the court determined that the measures taken for locating, financing, acquiring, maintaining, improving and selling real estate assets outside of Israel on a large scale are to be considered one business operation. Thus, the court held that even though each asset or shares were sold separately, the sales should be examined as part of a single business operation, and therefore the sales should be classified as business income and accordingly the CFC regime should not apply.

This case has a significant impact on the position of the Israeli Tax Authorities **(ITA)**, which argue that in such cases each of the sales should be examined separately and thus be classified as a capital tax event subject to the CFC regime. The ITA has been opposed to such structures since the enactment of the CFC rules fifteen years ago. The court, on the other hand, adopted a proper purposive interpretation that would greatly facilitate the activity of Israeli investors abroad - both in real estate and in other sectors. In light of the broad potential implications of the ruling and since the tax authorities are expected to appeal the case to the Supreme Court, the discussion on that matter seems not yet over.

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