

Israel-U.S. Tax Treaty Revamp May Mean Lower Withholding Rates

By Matthew Kalman

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- Officials aim to revise 25-year-old treaty to boost high-tech investment
- High rates out of sync with OECD, treaties with other countries

Israel could see a significant reduction in withholding taxes on capital gains, dividends, royalties, and loan interest in a revised treaty with the U.S.

"It's time to update and reduce the withholding taxes—it's very important when you restructure an investment," Daniel Paserman, a partner and head of tax at Gornitzky & Co. in Tel Aviv, said Oct. 23. "If the rates are high, it's an obstacle."

His comments come as the two countries announced Oct. 22 that a joint task force would work on modernizing the tax treaty set in 1993 and report on its progress at the 2019 meeting of the Israel-U.S. Joint Economic Development Group. The change for an update comes as Israel increasingly becomes a hub for multinational technology companies, and after the U.S. changed its tax code with 2017 tax reform.

Several clauses that depress cross-border investment need urgent reform, Israeli officials and practitioners said. Israel's emergence as a global developer of high-tech intellectual property and a series of international agreements have rendered the 25-year-old treaty obsolete, they said, pointing to nonrecoverable withholding taxes on dividends and interest rates that are among the highest of any Israeli or U.S. treaty.

The U.S. Treasury Department declined to comment.

Brake on Investment

The tax levels in the U.S.-Israel treaty are much higher than current models from the Organization for Economic Cooperation and Development, and are higher than the model of 5 percent and 15 percent Israel uses in its treaties with other countries, Sharon Aharoni, head of the Israel Tax Authority's International Tax Division, said at a Tel Aviv conference in June.

"We are trying to reach more modern rates," Aharoni said at the time.

The withholding tax rate on dividends is 25 percent in most cases, and withholding tax rates on interest are 17.5 percent, said Gil Raveh, founding partner of Raveh Haber and Co. Advocates in Ramat Gan. Raveh said the rates must be lowered to spur more investment and trade between the U.S. and Israel.

The treaty also doesn't "provide for a clear solution" on the taxation of trusts and beneficiaries, he said. The area requires special attention because Israel's rules on taxing trusts were enacted within the last decade, and are out of sync with the U.S., he said in an Oct. 22 email.

Although both countries provide an exemption on capital gains for foreign residents, Israel currently takes the tax position that an investment fund itself would be considered to have a permanent establishment, and thus it can impose income tax, he said.

"I would expect the treaty to provide clear relief here consistent with the U.S. rules," he said in the email.

Bridging the Gap

Still, some of the differences between the two countries may be too great to bridge. The revisions are unlikely to solve the mismatch in the way the U.S. and Israel tax trusts, which are a common device for wealthy Americans to structure estate and succession planning, Paserman said.

"I'm very skeptical whether it's realistic whether such a complex matter as the taxation of trusts will be solved in a tax treaty which generally will not give a comprehensive framework on how to tax trusts. I don't think a new treaty will solve that issue," he said.

The "exit tax" imposed by Israel on the sale of assets, including share options not yet realized, may also be beyond the scope of the new treaty, although it has been addressed in other recent agreements, including Israel's 2016 tax agreement with Austria, Paserman said.

"Israel wants to tax those Israelis even after they've moved abroad, when they realize those assets but they are no longer Israeli taxpayers," Paserman said. "It's very relevant to the U.S. because you have a lot of expats who relocate there; it's very common in high tech. It's also very complicated, particularly regarding options. I'm not sure the treaty can address all the issues."

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