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Corporate Tax: Doing Business in Israel in 2019

Daniel Paserman looks at the current corporate tax law in Israel and the US-Israel Tax Treaty.

CORPORATE TAX

Corporate Residency in Israel: A corporation is defined as an Israeli resident if one of two conditions are met: (i) its incorporation is in Israel; or (ii) its "management and control" is in Israel. Consequently, a foreign resident company is defined as a body of persons who is not an Israeli resident, as defined above (residual definition).

Worldwide Taxation: Israeli resident corporations are subject to tax in Israel on their worldwide income, whether it was produced or accrued in Israel or outside of Israel. Non-resident corporations are subject to tax in Israel only on the income produced or accrued in Israel (subject to relevant domestic laws and applicable tax treaties). In this respect, the Israeli Tax Ordinance **("ITO")** stipulates that business income shall be taxed in the jurisdiction in which the business activity took place; passive income (i.e., interest, royalties, dividends, etc.) shall be taxed based on the payor's place of residence; and capital gains shall be taxed in principal in accordance with the location of the sold asset.

The current corporate tax rate is 23%, and it may be reduced under certain specific tax regimes and reliefs.

Computation of Corporate Tax in Israel: The current corporate tax rate as of January 1, 2018 is 23%, and it may be reduced under certain specific tax regimes and reliefs (see below). The income on which the corporate tax shall be imposed is generally computed as income after deductions, set-offs, and exemptions; and subject to various adjustments stipulated in the ITO. Tax credits, if available, may be used against the computed tax amount. In general, the computation for tax purposes in Israel is generally based on the accepted accounting principles, unless specified otherwise within the ITO.

OFFSET OF LOSSES

Losses generally fall into one of three categories: (i) business losses; (ii) passive losses (e.g., losses in relation to interest, dividend, etc.); or (iii) capital losses. In general, the ITO allows to offset loss only if it would have been classified as profit and subjected to tax in Israel.

Israeli-Sourced Losses: Business losses accrued in Israel in any given tax year can be offset against income from any category generated in the same year. Such losses can be carried forward indefinitely against business income and capital gains which were generated in the business. However, passive losses accrued in Israel can be offset only against passive income, which is identical in its kind, and only during the current year.

Foreign Losses: Foreign business losses incurred during the current tax year will first be offset against foreign business income, including capital gains in the business, and the rest of the loss will be offset against foreign passive income. Foreign business losses that were not offset in their entirety within the current tax year (neither against business income nor passive income), but were incurred in a company which is managed and controlled from Israel, may be offset against Israeli income as well. The rest of the aforementioned foreign business losses may be offset against foreign business income in the following tax years. Notwithstanding, foreign passive losses can be offset only against other foreign passive income (and can be carried forward to future tax years).

TAX CREDITS

As mentioned above, Israeli resident corporations are subject to tax in Israel on their worldwide income. As a measure to avoid double taxation, the ITO enables a mechanism of foreign tax credits against Israeli tax for income of the same category for which the tax was paid abroad. Any excess of tax credit can be carried forward for a maximum period of five years.

Indirect Tax Credit: In general, where an Israeli resident corporation received dividends from a non-Israeli resident company (a subsidiary in which it has an interest of at least 25%, or a second-tier company in which it has indirect interest of at least 50%), the Israeli resident corporation is also entitled to a tax credit in the amount of the foreign corporate tax paid by the foreign subsidiary on its profits, from which the dividend was paid.

SPECIAL TAX REGIMES AND EXEMPTIONS

Special Tax Regimes: The Encouragement of Capital Investments Law (the **"Investment Law"**) provides special benefits for industrial and high-tech companies in Israel. In this respect, there are two main tax regimes currently suggested under the Investment Law (there is an additional tax regime which is no longer in force): (i) *the Preferred Enterprise Regime*, under which a company is entitled to a reduced corporate tax rate of 16% (unless the Preferred Enterprise is located in a specified development zone, in which case the rate is currently 7.5%). The company needs to meet certain conditions stipulated in the Investment Law in order to qualify as a Preferred Enterprise, such as being an Industrial Company; and (ii) *the Preferred Technology Enterprise Regime*, which is intended for high-tech companies that highly invest in R&D, and provides a reduced corporate tax rate of 12% (or 7.5% if the company's Preferred Technology Enterprise is located in a specified development zone). A company must meet certain conditions stipulated in the Investment Law in order to qualify

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as a Preferred Technology Enterprise, such as meeting a certain threshold of R&D expenses and total income of the company.

Participation Exemption: A participation exemption (i.e., exemption on capital gains, dividends, security's yields and interest and linkage differentials from financial institutions) applies to an Israeli holding company, if it holds shares in a foreign company and the following conditions are met: (i) the company was incorporated, controlled and managed from Israel; (ii) the company was not

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defined as a public company, financial institution, family company or transparent company; (iii) the company did not undergo a structural change or merger; (iv) the original cost of the foreign subsidiary's shares, in addition to the loan balance it lent to its foreign subsidiary, amounts to no less than NIS 50 million, and 75% or more of the original cost of all its assets; (v) the company did not have business income ; and (vi) the company chose to be an Israeli holding company, by all of its shareholders within 90 days after its incorporation.

Exemption from Capital Gains in relation to Israeli Companies' shares: Capital gains are generally taxed in Israel at a corporate tax rate of 23%. Notwithstanding, non-resident corporations are exempt from taxation on capital gains deriving from the sale of shares of an Israeli company traded on a stock exchange (unless the capital gains derive from their permanent establishment in Israel). Such exemption may also be given to the non-resident corporation in relation to the sale of non-traded shares (subject to certain conditions). Please note, however, that the aforementioned exemptions shall not be granted in relation to the shares of a company, whose assets mostly derive from real estate rights in Israel, the right to exploit natural resources in Israel, etc. Moreover, non-Israeli corporations will not be entitled to the foregoing exemption if Israeli residents: (i) have a controlling interest of more than 25% in such non-Israeli corporation or (ii) are the beneficiaries of, or are entitled to, 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly.

TRANSFER PRICING RULES

Pursuant to section 85A of the ITO, all cross-border transactions carried out between related parties should be conducted at arm's length, which represents the fair market conditions. In order to support the arm's length price, a transfer pricing study is required by Israeli tax law, and if requested by the ITA it should be submitted as part of the reporting requirements. Generally, the preferred pricing method in Israel for determining whether the terms of an examined cross-border transaction meet the arm's length principal is the comparable uncontrolled price (**"CUP"**). If the CUP Method is not applicable then the comparability analysis should be conducted in accordance with one of the following methods: (a) a profitability margin method (TNMM/CPM); or (b) the Profit Split Method (PSM) (or loss) between the parties; if these methods are not applicable, another suitable method should be applied.

*The Israel Tax Authority (the "**ITA**") Recent Publications:* In the past year the ITA has published three circulars that set out its approach on cross-border transactions involving distribution, marketing and sales and its position on the transfer pricing aspects following a business restructuring. As per the earlier circulars, the ITA stipulates the analysis to be performed in order to identify an activity and a suitable transfer pricing method thereof; the analysis focuses on the entity's functions, assets and risks (**"FAR"**). As an example, the circular states that the price for distribution activity with low risks (**"LRD"**) should be derived from its sales (as opposed to costs); further to this conclusion, the most appropriate method will be equivalent to the TNMM (transactional net margin method) as set out in the OECD Transfer Pricing

Guidelines. The circular provides an exemption from preparing a transfer pricing study where specific prices/rates are being applied (in the example above, a price for an LRD with 3% to 4% Return on Sales will be accepted by the ITA without presenting a study). As per the later circular (i.e., transfer pricing aspects following a business restructuring), the ITA automatically views any transfer of FAR as a business restructuring that must adhere to the arm's length principal. This subject is still in dispute among experts in the field. Furthermore, it is worthwhile to note that the ITA circulars express the ITA opinion, but they do not bind the taxpayers.

A fourth circular depicts the ITA's interpretation on intercompany loan treatment. According to the ITO, a loan that was given by an Israeli company to its foreign controlled subsidiary is excluded from the arm's length principal as long as the loan meets certain conditions, including: not bearing interest and linkage differential, having at least a 5-year maturity and it is subordinated to other debts. The circular clarifies the provision's conditions, and its applicability when parties to the transaction are reversed (i.e., when a loan is given by a foreign company to its related, controlled Israeli company).

FOREIGN TAX-"TRANSPARENT" ENTITIES

Tax Reliefs and ITA Circular: In general, a foreign entity with the characteristics of a corporation, will be treated as a company for Israeli tax purposes and therefore will be liable for tax at the corporate level, even though it is considered a "transparent entity" for tax purposes in its place of residence. For example, US LLCs and S Corporations are generally treated as corporations for tax purposes in Israel. Further, from an Israeli tax perspective, the taxation of an LLC's Israeli interest holders is neither regulated nor clear. Notwithstanding the above, according to an Israeli tax circular published by the ITA in 2004, in certain circumstances there is a special tax mechanism applicable with respect to foreign tax credits of an Israeli tax resident who holds interest in a US LLC which is treated in the US as a pass-through entity. The circular allows the Israeli taxpayer to elect to look through the LLC for Israeli tax purposes and to therefore attribute the LLC's taxable income to the Israeli interest holder; however, this is done only for the purpose of allowing the shareholder to receive a tax credit in Israel for taxes paid in the US. The circular explicitly states that it is limited only to foreign tax credits, and does not regard the LLC as a flow-through entity for all tax purposes. The aforementioned discussion raises other consequences, such as: LLC classification as a controlled foreign company (CFC), LLC's tax residence classification using the management and control status, etc.

Israel District Court Ruling: During 2017 the Israel District Court published a ruling which sheds some light and elaborates on the taxation in Israel of a US LLC, which is regarded as a pass-through entity from a US tax perspective. The court decision validated the content of the ITA Circular from 2004, and ruled that the classification of a foreign corporation with respect to its taxation in Israel shall be in accordance with the tax laws of Israel. Meaning, even in cases where a corporation is regarded as a pass-through entity in another country, it should be treated as an opaque entity from an Israeli tax perspective. This means that an Israeli tax resident who holds interests in the LLC shall not be entitled to tax credit in Israel on the taxes paid in the US on the LLC's income if such income is treated as a dividend in Israel.

In a district court ruling, published recently, the court decision emphasises once again the circular approach that for Israeli tax purposes LLC is considered as a pass-through entity only for tax credit, and therefore a shareholder of several LLCs cannot offset LLCs' losses against different LLCs' profits. The LLCs' losses and profits do not pass-through to the individual and should be treated within the LLCs as separate opaque entities.

CORPORATE MERGERS AND DIVISIONS

In general, according to the provisions of the ITO, mergers, splits, transfers of assets and shares transfers within a group of companies are considered taxable events under the ITO provisions. However, a tax deferral may be granted, provided certain conditions are met. In recent years there have been a few legislative changes allowing companies to ease the process of their restructuring. In this respect, it is worthwhile mentioning the shortening of the "Required Period" (in which the participating shareholders are prevented from exercising their shares which were transferred within the restructuring), and the allowance of issuing new rights during the said required period, under certain conditions.

US-ISRAEL TAX TREATY AND MLI

Tax rates under the US-Israel treaty are relatively high compare to new tax treaties to which Israel is party to. It is worthwhile mentioning that there are preliminary negotiations for a new treaty.

WHT Rates under the US-Israel Tax Treaty: In general, under the domestic law in Israel the following withholdings rates are applicable: (i) a 25% withholding tax is imposed on dividends paid by an Israeli resident company to a non-resident (higher rate of 30% applies when the recipient holds an interest of at least 10% in the company); (ii) a 23% withholding tax is imposed on interest paid by an Israeli resident corporation to a foreign corporation, and a lower rate of 15% may be applicable where the interest is paid to a foreign individual and does not include linkage differentials; (iii) a 23% withholding tax is imposed on royalties paid to a foreign corporation, and a 25% withholding tax is imposed on royalties where the recipient is an individual; (iv) the withholding tax rate with respect to capital gain is generally 25%. Notwithstanding, the above mentioned withholding tax rates may be reduced according to the US-Israel tax treaty. As such, if certain conditions are met, the distribution of dividends by an Israeli resident company to a US resident company may be subject to a reduced withholding tax rate of 12.5%; interest and royalty payments made to a US resident may be subject to withholding tax at reduced rates of 17.5% and 10% (respectively). Needless to say, the aforementioned tax reliefs are applicable also in the opposite direction (i.e., while payments are being made from a US resident company to an Israeli resident).

Permanent Establishment of a US resident Corporation in Israel: In principle, the tax treaties provide that a permanent establishment may be created by an entity mainly by one of the following: (i) the company has a fixed place of business through which it carries on its business, provided that the activity is not of a preparatory or auxiliary character; or (ii) the company conducts its activity using a dependent agent that habitually concludes contracts, or habitually plays a principal role leading to the conclusion of contracts that are routinely concluded without material modification by the company. In this respect, the possibility of double taxation may be avoided, or at least mitigated, through the provisions of the US-Israel Tax Treaty.

The MLI Provisions: The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (**"MLI"**) had developed over the recent years, in order to modify tax treaties between two or more parties. Among other issues, the MLI's measures and amendments give the competent authorities the responsibility to determine the taxpayer residency, where there is dual residency, through a mutual agreement. Moreover, the MLI modifies the tax treaty's provisions relating to permanent establishments. In this respect please note that Israel has started to implement the MLI's measures within its tax treaties as of January 1, 2019. However, the US-Israel Tax Treaty was not affected by the MLI's measures since the US did not sign the MLI. ■

ABOUT THE AUTHOR

Daniel Paserman, ADV (CPA) TEP, heads Gornitzky's Tax practice. He is involved in intricate corporate tax planning - both domestic and cross-border. His broad experience includes negotiations with the Israel Tax Authority regarding tax regulatory issues, seeking and obtaining tax rulings for both Israeli and global companies operating in Israel, as well as handling wide-scope tax assessment cases and tax litigation for both global and Israeli corporations and private entities operating in Israel. He has extensive experience in worldwide M&A transactions and has represented some of the leading Israeli corporations in multi-million dollar transactions, both in Israel and abroad.

In the field of private wealth, Daniel represents client in matters concerning taxation of trusts and estates and provides tax planning guidance for high net worth individuals. He also serves as the secretary of Society of Trust and Estate Practitioners Israel (STEP) and is a lecturer on Corporate & International Taxation at Tel Aviv University.