Ground Breaking International Tax Reform: Significant Influence on Corporations and Individuals

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The Israel Tax Authority (the "ITA") is currently attempting to enact a major international tax reform (the "**Reform**"), which may have a **great influence on corporations as well as individuals, either Israeli residents or foreign residents, with economic operations in Israel or personal ties to Israel.**

The Reform includes the following main tax proposals related to individuals and corporations. Below is a brief summary of the main amendments proposed:

A. CHANGE IN DETERMINATION OF TAX RESIDENCY OF INDIVIDUALS

- As of today an individual is considered an Israeli tax resident if her/his "center of life" is in Israel, a facts and circumstances test, which examines the individual's family, economic and social ties. In addition, there are two rebuttable presumptions measuring the number of days the individual has spent in Israel. In essence, the presumptions examine whether an individual spent more than 183 days in Israel in a tax year, or whether s/he spent 30 days or more in a tax year in Israel and the total period of her/his stay in Israel in three consecutive tax years tax year was 425 days or more.

- The presumptions can be rebutted, by both the individual and the Israel Tax Authority, and the party that wishes to rebut them is subject to the burden of persuasion of proving that the center of the individual's life is not in Israel. In accordance with the generally accepted approach, the numerical presumptions are one-sided positive presumptions. In other words, an individual who does not fall under these presumptions is not automatically deemed to be a person whose place of residence is abroad.

- The Reform introduces **new conclusive (irrebuttable) presumptions in order to determine the tax residency of individuals in Israel.** Essentially, it is proposed to determine that an individual will be considered an Israeli tax resident if one of the following applies:

  a. S/he stays in Israel for more than 183 days each year over the course of two consecutive tax years; or

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b. S/he stays in Israel for more than 100 days in a current tax year, and more than 450 days over the course of the three recent tax years. This presumption will not apply if the individual stays 183 days or more in a country with whom Israel has signed a tax treaty ("**Treaty Country**"), and obtains a certificate of residency therefrom; or

c. S/he stays in Israel for more than 100 days in a current tax year, and her/his spouse or individual with whom s/he maintains a mutual household is an Israeli tax resident.

- At the same time, the Reform also introduces conclusive presumptions determining that an individual is a foreign tax resident, namely if:

a. S/he spends less than 30 days per tax year in Israel, during each of the recent 4 tax years – s/he will be a foreign tax resident from the beginning of the 4 year period; or

b. S/he spends less than 30 days per tax year in Israel, during each of the recent 3 tax years, s/he will be a foreign tax resident starting at the beginning of the second tax year.

The conclusive presumptions provided in subsections a and b will apply under the condition that no more than 15 days are spent in Israel during the first month of the first tax year or during the last month of the last tax year.

c. An individual and her/his spouse spend less than 60 days per tax year in Israel, during each of the recent 4 tax years – they will be foreign tax residents from the beginning of the 4 year period; or

d. An individual and her/his spouse spend less than 60 days per tax year in Israel, during each of the recent 3 tax years, they will be foreign tax residents from the beginning of the second tax year.

The conclusive presumptions provided in subsections c and d will apply under the condition that no more than 30 days are spent by the couple in Israel during the first two months of the first tax year or during the last two months of the last tax year.

e. An individual and her/his spouse spend less than 100 days per tax year in Israel, during each of the recent 4 tax years – they will be foreign tax residents from the beginning of the 4 year period, only if they spend more than 183 days in a Treaty Country, and obtain a certificate of residency therefrom; or

f. An individual and her/his spouse spend less than 100 days per tax year in Israel, during each of the recent 3 tax years, they will be foreign tax residents starting at the beginning of the second tax year, only if they spend more than 183 days in a Treaty Country, and obtain a certificate of residency therefrom.

- The conclusive presumptions provided in subsections e and f will apply under the condition that no more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.

- The "center of life" test will remain relevant for cases where the conclusive presumptions

(mentioned above) will not apply.

B. TAX BENEFITS TO NEW ISRAELI RESIDENTS AND RETURNING RESIDENTS

- Since 2007, an individual who has become an Israeli tax resident, whether for the first time or after spending considerable time outside Israel as a foreign tax resident, is entitled to material tax and reporting benefits.

- New Israeli residents and veteran returning residents are entitled to tax and reporting exemptions with respect to foreign income and assets for a period of 10 years, commencing on the date they became Israeli tax residents.

- **The Reform is expected to abolish the exemption from reporting with respect to foreign income and assets,** but to date, there is no suggestion to implement changes to the substantial tax exemption.

C. EXIT TAX

- Israeli tax law imposes an exit tax on an individual or an entity that ceases to be a tax resident, which means that the assets of an Israeli who terminates his residency are considered to have been sold on the day prior to the day on which they ceased to be an Israeli tax resident. According to the current law, there is an option to postpone the tax payment to the actual sale event (instead of paying on the date of leaving Israel).

- The Reform includes **additional reporting obligations and depositing guarantees** on taxpayers that wish to postpone the tax payment to the sale event, and cancels the option to postpone the tax payment under certain circumstances, and regarding different assets; whereby:

  a. If the value of the assets subject to exit tax, as of the date of the terminat lower than NIS 3 M ion of the Israeli residency, is, the taxpayer may postpone the tax payment to the realization date. However, the taxpayer will be obligated to file financial reports relevant to the year the exit tax was to apply, which shall include the scope of assets and the deemed income which would have derived from their sale. In addition, the taxpayer must file a capital declaration listing all of the assets upon which the exit tax is levied.

  b. If the value of the assets, subject to exit tax as of the date of the termination of the Israeli residency, is higher than NIS 3 M, then the assets will be split into categories, each of whom will be treated separately with respect to the exit tax:

     i. Tradable securities will be regarded as though they have been sold on the date of the termination of the Israeli residency, and will be taxed and reported accordingly;

     ii. Real estate located abroad, will entitle their owner the choice between two tracks: the immediate payment of exit tax and the postponed payment. Should the taxpayer choose to postpone the payment, it will have reporting obligations. In addition, if the tax is estimated to exceed the total of NIS 1.5 M, it may be required to deposit the foreign real estate by an Israeli nominee.

     iii. Other assets, will entitle their owner to the choice between immediate payment of exit tax and the postponed payment. Should the taxpayer choose to postpone the payment, it may be required to deposit the assets by an Israeli nominee, and to meet additional reporting requirements.

- The Reform also includes **additional provisions whose main purpose is to prevent tax avoidance.** These provisions will impose an "exit tax" in cases that are not taxed under current law, such as dividend income received from a foreign company to a taxpayer who

ceased to be an Israeli tax resident before the date of the distribution of the dividend, and until the period of the realization of entitling shares, assuming the taxpayer chose to postpone the payment on the exit tax.

- Another recommendation is to impose taxes on assets that were sold during a limited period commencing from the day the taxpayer ceased to be an Israeli resident and ending 4 years thereafter, and the tax will be calculated as though the taxpayer was still an Israeli tax resident, meaning the taxpayer will be subject to a "full" tax payment as if has never left Israel.

- Another recommendation is to impose "exit tax" on the transfer of intangible assets of an Israeli company or an Israeli permanent establishment of a foreign resident to the headquarters or to another entity abroad. In such a case, there will be no option to postpone the tax payment to the realization date.

- The Reform suggests imposing exit tax on the accumulated earnings of a company that was classified as an Israeli tax resident by virtue of its control and management from Israel, without the option of postponing the tax payment. The accumulated earnings will include the earnings that will be derived from the deemed sale of the company's assets.

- It is clarified that the provisions of immediate payment of exit tax will be applied also in cases where an Israeli company transfers its assets or business activity outside Israel.

D. CONTROLLED FOREIGN CORPORATION ("CFC").

- Controlled Foreign Corporation (CFC) rules, as they apply in Israel today, provide, under certain conditions, that passive income of a foreign corporation controlled by Israeli residents is considered "deemed dividend", distributed to the Israeli shareholders.

- The Reform will **expand the definition of passive income** to include, inter alia, income derived from proceeds (interest, insurance, or royalties, all under specific conditions) received from related parties, income generated from business activity served for-profit shifting, and capital gain derived from intangible assets.

- The Reform will **reduce the passive income threshold** to 1/3 of the total income or profits of the foreign company (instead of the current threshold of 1/2).

- The Reform includes **stricter conditions** in order to apply the CFC rules for cases in which the corporation is a resident of a country that is in the "black" and "gray" lists of the EU (excluding Treaty Countries), or a resident of a country that does not have an agreement with Israel that allows the exchange of information. These stricter conditions include the reduction of the Israeli ownership share to 30% (instead of 50%), and the application of the CFC rules to all passive income, regardless of their share in the total income or profits.

- As part of the Reform, **the holdings of new residents and veteran returning residents will be considered holdings of Israeli residents** (as opposed to the situation which applies today where their holdings are considered of foreign residents) and will be taken into account while determining whether a foreign corporation is a CFC. This provision will apply only with respect to assets purchased after the move/return to Israel.

F. FOREIGN TAX CREDIT

- As of today Israel grants direct foreign tax credit for taxes paid on foreign income.

- It is suggested to narrow the current number of "baskets", so that foreign income will be classified according to the following 5 baskets:

1. Passive income;

2. Active income;

3. Capital gains;

4. Controlled Foreign Corporation ("CFC");

5. Professional Foreign Corporation ("PFC").

- It is suggested to **tighten the rules concerning the receipt of credit for taxes paid abroad** in certain cases and in certain countries, for example, in countries that are included in the "black" or "gray" lists of the EU.

- As of today, a taxpayer can use the credit through the following 5 years. It is suggested to **abolish the option to use excess credit in the following years, except in specific cases.**

- Today where an Israeli company receives dividends from a non-resident company in which it holds at least 25%, the Israeli company is entitled also to an "indirect" credit for foreign corporate tax paid by the non-resident daughter company on the profits from which the dividend was paid ("indirect tax credit"), subject to certain conditions. An indirect tax credit is also available where the daughter company holds at least 50% of a subsidiary of its own (a granddaughter company of the parent company).

- The Reform will **expand the indirect tax credit rules** so that they will apply also where an Israeli company holds indirect subsidiaries (two additional tiers down the chain of holdings in addition to the daughter and the granddaughter companies), provided that the effective holding rate will be at least 12.5% in each indirect subsidiary (in the third-tier subsidiary and fourth-tier subsidiary) and the holding rate between the third-tier and fourth-tier subsidiaries will be at least 50%.

- The Reform includes adding a provision stating that the holding condition for applying the indirect tax credit will be carried out for the last 12 months prior to the dividend distribution date.

LLC

- As of today, the Israel Tax Authority's approach allows an Israeli shareholder of a US LLC, which is treated in the US as a look-through entity, to attribute the LLC's taxable income to the Israeli holder, only for the purpose of allowing the holder to receive a tax credit in Israel for taxes paid in the US. The ITA's approach explicitly states that the LLC will not be regarded as a look-through entity for all tax purposes such as for the offset of losses.

- It is proposed to change the ITA's approach in the manner that **losses from an LLC will be offset against the income of the Israeli holder from US sources and assets only,** which the Israeli holder owns and was also offset in the US. It is emphasized that the election of the ITA's approach is irrevocable and should be done in the first year of submitting a return.

G. TAXATION OF EXERCISE OF OPTIONS AND WORK INCOME THAT WERE PARTIALLY VESTED WHILE THE INDIVIDUAL WAS A FOREIGN TAX RESIDENT

- According to the ITA's approach, an employee's income is calculated on a cash basis so that on the date the employee receives the income, the tax treatment is determined according to her/his tax residency (also with respect to options that were granted and/or vested while the employee was a foreign tax resident).

- It is recommended to introduce a temporary order intended to encourage the return to Israel, according to which **the employee will be exempt from tax in Israel in respect of the portion that was vested abroad, even if the income was received after the return of the employee to Israel.**

H. STEP UP

- As of today, the ITA allows a "STEP UP" in the basis of foreign assets received from a foreign tax resident to an Israeli tax resident by way of gift or inheritance.

- It is suggested to choose one of the following options: (i) **abolish the existing "STEP UP" mechanism regarding foreign assets entering the Israeli tax net**; or (ii) add a "STEP IN" mechanism with respect to assets bequeathed to a foreign tax resident by an Israeli deceased (meaning a capital gain tax payment upon inheritance to a foreign tax resident), and at the same time to legislate the "STEP UP" mechanism in relation to foreign assets entering Israel.

I REPORTING OBLIGATIONS

- It is suggested to impose **reporting obligations on foreign companies** that fulfill the following conditions:

  i. at least 50% of the company's shares are held by Israeli tax residents;

  ii. the applied foreign tax rate is not more than 15%; while the company is (a) not a resident of a treaty country or; (b) not taxed in its residency country on income accrued from abroad;

  iii. At least one of the following conditions applies: (a) More than 50% of the board members (or equivalent body), directly or indirectly, are Israeli tax residents; (b) The main activity is in Israel and/or most of the company's value derives, directly or indirectly, from Israeli assets; (c) The average annual number of days spent in Israel by the company's officers is higher than 183 days; (d) At least half of the company's officers are Israeli tax residents; (e) The location of half of the company's officers is in Israel.

- It is suggested to impose a **reporting obligation on Israeli shareholders who hold, directly or indirectly, more than 50%** of a foreign corporation's means of control, including a requirement to **attach the foreign corporation's financial statements and to present details** on income, expenses, gain, assets and its directors, management members, and shareholders.

- It is suggested to add **a reporting obligation on an individual who received a payment or a gift from abroad in an amount above NIS 500,000.**

To complete the picture, it should be noted that the Reform includes complicated and broad recommendations regarding hybrid entities based on Action 2 report of the OECD. A this point it is unclear whether this chapter will be promoted as part of this Reform. ■

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