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Recent developments in international taxation – Israel

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Recent highlights

During the majority of 2019 and the beginning of 2020, the most significant international tax developments that took place in Israel include several court rulings, the most prominent of which addresses certain transfer pricing aspects relating to post-acquisition business restructuring and certain bilateral income tax treaties. Legislation in Israel, in general and in the tax field specifically, was scarce during the past year as a result of three consecutive election cycles immediately followed by the worldwide Covid-19 crisis. Significant legislation is expected to be introduced in the near future.

Business restructuring

The District Court published its ruling in the *Broadcom Semiconductors Ltd v Tax Assessor of Kfar Saba* case (the 'Broadcom Ruling'), which dealt with tax aspects of business model restructuring by multinational groups. The Broadcom Ruling rejected the position of the Israel Tax Authority (the 'ITA') that argued that the change of the business model of the appellant constitutes a sale of an intangible asset, described as the functions, assets and risks of the company (FAR). It is worth noting that while decisions of the District Court do not constitute binding precedent, the ITA decided not to appeal the ruling to the Israel Supreme Court.

The Broadcom Ruling is the most recent development in the issue of the tax consequences of a business model change, a matter which is commonly raised in recent years in tax audits of Israeli companies that were acquired by multinational groups, and subsequently transferred (or deemed transferred) their intellectual property to a non-Israeli affiliate.

Prior to the Broadcom Ruling, the ITA took an aggressive approach, which was detailed in a comprehensive circular published in 2018, according to which practically every business model change constitutes a FAR sale. The ITA's position was presumably based on OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations from 2017 and a previous District Court decision in the *Gteko v Tax Assessor of Kfar Saba* case (the 'Gteko Ruling'), in which the court ruled in favour of the ITA. However, some deviations from both authorities were apparent in the ITA circular.

In the Broadcom case the ITA argued that an Israeli subsidiary that was acquired by the Broadcom group, and subsequently sold part of its intellectual property (IP) to a non-Israeli entity in the Broadcom group and transformed into an R&D centre, should be subject to tax for the sale of a FAR asset. While the court accepted the notion that a business model change may rise to the level of a FAR transaction, it distinguished the Broadcom case from the Gteko Ruling, in which the acquired Israeli subsidiary divested of all its assets and essentially turned into an 'empty shell'. The fact that Broadcom Semiconductors Ltd remained an operating and profitable R&D centre post-acquisition was pivotal in the court's decision to reaffirm the taxpayer's original reporting position.

The Broadcom Ruling is an important development in a key matter in many tax assessments issued to multinational groups in Israel in recent years and may serve as a roadmap for taxpayers regarding the dos and don'ts in business model changes in Israel.

Israeli holding companies' taxation

The Israel Supreme Court published its decision in an appeal filed by the ITA in the *Tax Assessor of Netanya v Delek Hungary Ltd* case (the 'Delek Ruling'). The Delek Ruling deals with the taxation of capital gains by Israeli holding companies that sell shares of offshore companies.

Under Israeli law, in a stock sale transaction a portion of the capital gain that equals the distributable earnings of the sold company, is subject to tax as dividend income (the 'distributable earnings rule'). This provision is mainly applicable in a sale of shares of an Israeli company by an Israeli corporate shareholder, since domestic intercompany dividends are exempt from tax in Israel. The Supreme Court was presented with the question whether the distributable earnings rule also extends to the sale of shares of a foreign company, where the selling Israeli holding company is entitled to foreign tax credit for dividends distributed by the sold foreign subsidiary.

The facts of the Delek Ruling centred on Delek Hungary Ltd ('Delek Hungary'), an Israeli resident holding company that held 68 per cent of the share capital of a publicly traded US subsidiary. In the tax years in appeal, Delek Hungary sold the stock of its US subsidiary. In its tax reporting Delek Hungary reduced its capital gains tax liability by approximately USD100m, arguing that the portion of the capital gain that is attributable to the distributable earnings of the US subsidiary constitutes a deemed dividend that is subject to zero per cent tax in Israel because of Israel's foreign tax credit rules (which may include indirect foreign tax credit).

Delek Hungary's position was accepted in the lower court, but the ruling was reversed on appeal. The Israel Supreme Court ruled that the distributable earnings rule does not apply to earnings that were not subject to Israeli income tax. The Delek Ruling creates a significant tax advantage for Israeli companies that can induce tax distributions by offshore subsidiaries prior to a share sale transaction.

Stock-based compensation

The Nazareth District Court published its ruling in *Tal Shohat v Assessor of Safed* (the 'Shohat Ruling'), which is the most extensive and significant court ruling to date with respect to taxation of employee equity compensation plans.

The main question at the centre of the Shohat Ruling was whether certain shares issued to the taxpayer are entitled to preferential tax treatment, reserved for approved equity compensation plans, or whether they constitute a disguised bonus payment. The shares in question were preferred shares that carried only dividend rights. The shares were non-transferrable and were to become dormant upon termination of employment.

The District Court ruled that the shares meet the requirements for preferential tax treatment under Israeli law and denied the ITA's position that the dividends should be reclassified as ordinary income. Furthermore, the court ruled that once an equity compensation plan has been approved by the ITA or is deemed approved due to the lapse of the 90-day period in which the ITA can disqualify a plan, the ITA will generally not be able to claim that the plan is noncompliant with Israeli law requirements.

The Shohat Ruling provides significant additional certainty regarding Israeli tax consequences of issuing awards pursuant to an approved equity compensation plan. We note, however, that the ITA has filed an appeal to the Israel Supreme Court.

An additional significant development in the field of stock-based compensation is the publication of Reportable Position 70/2019. Reportable positions are a list of positions that the ITA perceives as aggressive tax planning. Taxpayers taking such positions may be required to provide additional disclosure in their tax returns, if a certain tax savings threshold is met. The list of reportable positions provides insight to the interpretation of Israeli tax law by the ITA (although the reportable positions are not legally binding other than a reporting obligation).

Reportable Position 70/2019 provides that if an Israeli subsidiary paid to its employees a stock-based compensation, using the shares of its non-Israeli parent corporation, and the transaction was recorded in the financial statements as an equity-settled award, then the ITA will view the transaction as a capital investment of the parent company in the Israeli subsidiary. Accordingly, any recharge payments that the Israeli subsidiary makes may be classified by the ITA as dividend distributions or reduction of capital, as applicable, and may be subject to withholding obligations.

Tax treaties

The tax treaty agreements that Israel has signed with the United Kingdom, Australia and Serbia have come into effect on 1 January 2020.

Expected legislation

As mentioned above, three consecutive election cycles in Israel, immediately followed by the global Covid-19 challenge, have impeded new legislation during the past year. As a result, significant new legislation is expected to come down the pike.

Specifically, a new 'Angels Act' bill is expected to be introduced. The bill is meant to replace existing legislation, which provides tax benefits to angel investors in startup companies, that is expected to expire soon after a new government will be formed. In addition, Israel is considering legislating a portfolio interest exemption. The ITA is also pushing for changes in legislation that will allow it to charge VAT on 'digital economy' transactions.

A stimulus and tax benefits package are likely to be pushed forward in response to the Covid-19 crisis. Some limited financial measures have already been put into place (most notable are grant payments to sole proprietors and payments to households with children, elderly or disabled individuals). It remains unclear what will be the exact scope of government support, but it is highly likely that additional steps will be taken in order to reignite economic activity.

Finally, the ITA has formed an internal task force focused on international tax reform. The task force is expected to mainly include suggestions in connection to international tax legislation in an attempt to close loopholes and curve aggressive tax planning.