Recent Developments in International Taxation

Israel

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Recent highlights

During the majority of 2021 and the beginning of 2022, the most significant international tax developments that took place in Israel involved several court rulings. Legislation in Israel – in general and in the tax field specifically – was scarce during the past few years as a result of several consecutive elections and the worldwide Covid-19 pandemic crisis, which diverted legislative efforts in other directions. Significant legislation is expected to be introduced in the near future; however, it will probably be postponed further due to another expected election cycle.

Transfer of functions, assets and risks to a related party

On May 2022, the Tel Aviv District Court issued its ruling in the Medingo case, in which the court was asked to review the decision of the Israel Tax Authority (ITA) to tax the appellant in connection with a deemed transfer of its functions, assets and risks (FAR) to a related party. The issue of FAR transfers has been a frequent point of contention in Israeli income tax audits over the last decade, as the ITA routinely claims that local tech companies that are acquired by multinationals transfer their FAR immediately following their acquisition.

The ITA’s position is arguably based on the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines with respect to business reorganisations and changes of business models. FAR transfers have been the focus of two separate court rulings issued by the Central Region District Court in recent years:

- the Gteko case, in which the ITA prevailed and a FAR transfer was deemed to have occurred; and
- the Broadcom case, in which the taxpayer prevailed and the court ruled that there was no FAR transfer.

In the Medingo case, the appellant was acquired by a multinational group. Shortly after, it licensed its legacy intellectual property (IP) to a related party within the multinational group and started providing research and development (R&D), marketing, technical support, administration, consultation, and support and manufacturing services to other related parties. These actions prompted the ITA to argue that the appellant effectively transferred all of its pre-acquisition FAR.

The Medingo court followed the Broadcom ruling and rejected the ITA’s claims. The court reviewed two separate questions in this matter. First, it reviewed whether the intercompany agreements, disregarding the fact that they were entered into between related parties, should be viewed as a sale of the business activity of the appellant. The court answered in the negative by analysing the changes in the functions, assets and risks of the appellant and whether such changes meant that FAR was indeed transferred.

Functions

The court determined that the appellant continued its activity, including with respect to its R&D, manufacturing, marketing and management functions. The court rejected the ITA’s claims that the management and decision-making regarding these functions were transferred from the appellant. In this respect, the court approved the taxpayer’s position that a shareholder that ‘sets the [business] policy’ of a company should not be viewed as
effectively acquiring the functions of the company. The court noted further that the main relevant function is conducting the actual R&D (and not the management of the R&D function) and that the R&D budget was decided in cooperation between both parties to the agreement.

Assets

The court concluded that the legacy IP remained in the possession of the appellant and was not transferred. The licence agreement was for a limited period only, following the expiration of which the buyer acquired the legacy IP from the appellant in order to continue to exploit it. The buyer was also not allowed to license the IP to unrelated parties. Importantly, the court also rejected the ITA’s claim that it is not possible to differentiate the ‘legacy IP’ from the ‘new IP’ developed under the R&D services agreement. It also rejected the claim that the useful life of the IP was limited to the duration of the licence agreement, as the buyer in fact acquired the IP after the end of the license period.

Risks

The court accepted the appellant’s arguments that it has not divested of its business risks, recognising the risk of having only one client and the fact that the royalties and continued activity of the appellant depend on the business success of the products manufactured based on the legacy IP (even if to a lesser extent than before). The court rejected the ITA’s position that reducing risks is indicative of a sale of business activity, stating that the main question is whether the appellant became indifferent to its business activities and results following the signing of the intercompany agreements, or whether it continued to develop its business – even if under different conditions. Since the appellant clearly did not abandon its business activity (in contrast to what occurred in the Gteko case, in which the taxpayer transferred its IP and workforce and remained an ‘empty corporate shell’), the risk analysis cannot lead to the conclusion that the business activity was sold.

The second question was whether the fact that the parties are related affected the characterisation of the agreements such that the agreements should be effectively viewed as a sale of the business activity.

The Court referred to the OECD transfer pricing guidelines that instruct tax authorities in characterising transactions among related parties and the proper transfer pricing of the transaction. The Court noted that under these OECD guidelines, the characterisation of the transaction would be different from the actual agreements between the parties only in rare cases where the ‘agreements are fundamentally unfounded or do not allow by any means to determine an arm’s length price’.

With respect to the characterisation of the transaction, the Court found that the licensing and R&D agreements are common among unrelated parties and therefore the ITA cannot argue that the characterisation of the agreement was necessarily affected from the relationship between the parties. Accordingly, the Court found that the ITA can, at most, challenge the pricing of these transactions. The ITA made no arguments with respect to the arm’s length consideration that should have been paid in these intercompany transactions.

The Court noted the business logic behind the appellant entering into these agreements and the fact that the product had not been profitable up to the acquisition. The intercompany
agreements actually provided the appellant with greater chances of survival and ensured its future. In this context, the court criticised the ITA for taxing the appellant in hindsight and noted that, under the OECD transfer pricing guidelines, a transaction will be re-characterised only if there is a ‘clearly more attractive opportunity’ [emphasis in source]. The ITA cannot reclassify a transaction simply because the appellant had other business opportunities.

The Medingo ruling is another hit to the ITA’s broad view of FAR sale transactions. Israeli case law continues to evolve in this field, which is extremely relevant to multinationals operating in Israel. Similar to the Broadcom court, the Medingo court ruled that the ITA has taken the FAR assessments a step too far, and provides a detailed and comprehensive roadmap to taxpayers that wish to ensure that their transactions will be respected for Israeli tax purposes.

**Classification of dividend income for returning residents**

On April 2022, the Be’er Sheva District Court issued its ruling in the Yaron Meir case in which the court was asked to review the decision of the ITA to tax the appellant in connection with classification of dividend income from a foreign country.

To set the scene, the appellant was entitled to tax benefits as a returning resident after spending more than five years outside Israel. These benefits include an exemption from tax on foreign source dividends (and certain other passive incomes) derived from shares held prior to the taxpayer’s return to Israel. However, business income is not exempt from tax, regardless of whether it is foreign or Israeli sourced income.

The appellant in the Yaron Meir case held shares of a British Virgin Islands (BVI) company, which in turn owned a Tanzanian subsidiary that had local operations in Tanzania. The appellant served as the chief executive officer of the subsidiary until approximately two and half years before his return to Israel, and as an employee of the BVI company from its establishment until his return to Israel. Following the appellant’s return to Israel, the services previously provided by the appellant began to be provided by the appellant’s sister (who was a foreign resident). The appellant received monthly or bi-monthly dividends from the BVI company.

The ITA claimed that the dividend income should be recast as business income, arguing that the BVI company received millions of dollars in fees from its subsidiary – although it has only one employee – and that the recurrent dividends were meant to compensate the shareholders for their services.

According to the appellant, the distributions he received were dividends originating from the profits of the BVI company, since the distribution policy in the company was to distribute on an ongoing basis in accordance with the creation of the profits.

The court rejected the ITA’s position and ruled that the true nature of the income from BVI is a dividend, and there was no reason to classify the dividend income as directors’ fees or management fees. The court found that the payments should be classified as dividends under general corporate law and that there is no basis to reclassify these payments under tax law as any kind of substitute to ordinary income.
The Yaron Meir ruling is meaningful to Israeli taxpayers (such as new immigrants or returning residents) that enjoy tax benefits on foreign source income. The ruling limits the ITA’s authority to reclassify exempt foreign source income as taxable Israeli income in situations where there is no clear and strong evidence of unlawful tax planning.

**Recommendations of the International Taxation Reform Committee**

The ITA’s Committee to Reform International Tax has filed its report to the Director of the ITA. This committee, in which members of the Israel Bar Association and the Institute of Certified Public Accountants in Israel also participated, recommended significant legislative changes in the provisions of the Israeli Income Ordinance relating to international taxation to:

- deal with enforcement difficulties and lack of information;
- close tax loopholes; and
- reduce the risk of money laundering related to international taxation.

The committee’s recommendations do not have any current effect and will require extensive legislation to implement. The ITA is expected to push for such legislation in the future, but the current political situation in Israel continues to be vague; accordingly, it is hard to estimate when such legislation could be enacted. Below is a short summary of some of the main recommendations included in the committee’s report.

**Individual residency**

An individual who is considered a resident of Israel is taxed on their worldwide income and is subject to broader reporting obligations than an individual who is not a resident of Israel. Under existing law, an individual will be considered a resident of Israel if that person’s ‘centre of life’ is in Israel.

The existing law results in many disputes between the ITA and taxpayers regarding the ‘centre of life’; the level of certainty regarding an individual’s residency, both for the ITA and the taxpayers, is relatively low. To improve the certainty on this matter, the committee recommends legislating a number of irrefutable presumptions, based on the number of days spent in Israel, which will be decisive in determining individual residency. Where the conditions of the irrefutable presumption are not met, the taxpayer’s residency will be determined according to the existing ‘centre of life’ test, including the rebuttable presumptions under existing law.

**Foreign tax credit**

In order to avoid double taxation of income that is also taxable in another country, Israeli law currently stipulates that foreign taxes that were paid in a foreign country by an Israeli resident can be credited against Israeli tax liability, subject to certain restrictions and conditions. These limitations include allocating foreign taxes to various ‘baskets’ determined based on the type of income for which the tax is paid and limitations on claiming foreign tax credits in one basket against income from another basket. The current basket system is quite complicated and raises difficulties, which may result in a loss of the credits for taxes paid in a foreign country. The committee recommended:
• reducing the number of baskets to five only – active income, passive income, capital gains, controlled foreign corporation (CFC) income and foreign professional company income;
• limiting carry forward of the excess credit to subsequent years; and
• limiting taxpayers’ ability to claim foreign tax credits that were claimed in another jurisdiction and more.

Exit tax

Under existing law, a person (individual or company) who ceases to be an Israeli resident is liable to exit tax as if they had sold all of their assets on the date in which they ceased being an Israeli resident. As a default, the taxpayer is viewed as if they had elected to defer the date of payment of exit tax until the date of actual sale of the assets. At the time of the actual sale, the exit tax will apply only in respect of the proportionate share of the gain on the sale that is allocable to Israel. This is calculated as the number of days in which the property was held until the termination of Israeli residence, divided by the total number of days in which the property was held until sale (the ‘linear method’).

The committee recommends extensive changes to the provisions relating to exit tax, which are primarily intended to ensure the ability of the ITA to effectively collect the tax. Like the current law, taxpayers who have terminated residency will be allowed to elect whether to pay the exit tax immediately or postpone the tax payment to a later date. However, the Committee recommends that both routes will have more extensive reporting obligations, and that the assessing officer will be entitled to demand certain guarantees to secure future tax payment. In addition, the exit tax with respect certain asset classes could not be deferred under the new regime.

Controlled foreign corporations

The committee recommended significant changes to the CFC legislation, including introducing new types of CFC income and lowering the threshold for foreign corporations to be classified as CFCs for Israeli tax purposes.

Reporting obligations

The committee recommended greatly expanding Israeli reporting obligations with respect to ownership of foreign corporations, and involvement of taxpayers in certain international transactions (similar to the European Union’s DAC 6 standards of reporting) and so on.

Hybrid mismatch

The committee recommended adopting the base erosion and profit shifting (BEPS) 2 principles with respect to treatment of hybrid entities and hybrid arrangements in order to minimise cross-border mismatches.

The committee’s report also includes various additional recommendations regarding provisions relating to Israeli international tax provisions.