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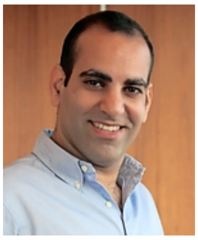
Israeli Taxation Trends and Key Changes in 2017



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There are many developments to Israeli taxation in the pipeline for 2017. These developments are a result of efforts on the Israeli Government's part to align with the new tax standards of the OECD on the one hand and its effort to make Israel more approachable and alluring for both Israeli and foreign investors on the other hand.

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I. The New Budget Law

On December 22, 2016 the Economic Efficiency Law for 2016 (legislative amendments for implementing the Economic Policy in 2017 and 2018), (the "Budget Law") was approved by the Israeli Parliament. The Budget Law includes a series of reforms and tax cuts. Below is a short summary of a few of the Budget Law tax changes, which came into force as of January 1, 2017.

A. Reduction of Dividend Withholding Tax

According to the Budget Law, individual tax rates as well as corporate tax rates were reduced as of the tax year 2017. Thus, the marginal tax rate for individuals was reduced from 48 percent in 2016 to 47 percent in 2017 and thereafter with several minor changes within the tax brackets. However, the excess tax was increased from 2 percent on annual taxable income above 810,720 shekel in 2016 to 3 percent tax on annual taxable income above 640,000 shekel in 2017.

Additionally, the Budget Law reduces the corporate tax rate from 25 percent in 2016 to 24 percent in 2017 and to 23 percent in 2018 and thereafter. Such reduction is in line with the previous legislative acts of Israeli policy makers, according to which the corporate tax rate was reduced from 26.5 percent in 2015 to 25 percent in 2016.

B. Special Tax Reduction on Dividends Distributed from Past Retained Earnings

As part of the Budget Law, the Israeli parliament approved a temporary provision according to which a "substantial shareholder" will be subject to a lower tax rate on dividends distributed to him between January 1, 2017 and September 30, 2017 ("Special Provision").

According to this Special Provision, an individual or a "family company" (a transparent company) that qualifies as a substantial shareholder, (i.e. holding of 10 percent or more) receiving a dividend originating from earnings accumulated up to December 31 2016, will be entitled to a reduced tax rate of 25 percent instead of 30 percent and will pay no excess tax.

Under the Special Provision, an individual may be entitled to this reduced tax rate on dividends, only if the total payments (such as salary and management fees) that shall be paid to him directly or indirectly, during the years 2017–19 by the company distributing the dividends, will not be lower than the average sum of such payments made to the individual in the years 2015–2016.

C. Tax Incentives for Technology Companies Operating in Israel

In general, the Law for the Encouragement of Capital Investments, 5719-1959 ("Encouragement Law") provides various tax incentives to manufacturing companies that fulfill certain objectives. Throughout the years, the law has been amended numerous times and different benefits have been provided. In 2011, the Encouragement Law was amended significantly and introduced a new reform in its provisions, known as the "Preferred Enterprise Regime." According to this regime, manufacturing and exporting companies that meet certain conditions and requirements may be entitled to a reduced tax rate of 16 percent or to a lower rate of 9 percent if the company is located in a preferred area "A" in Israel. This regime also provides a reduced withholding tax rate of 20 percent on dividend distributions.

The Budget Law introduced a few significant amendments to the Encouragement Law in order to attract investors from abroad and substantially increase Israel's competitiveness. One amendment provides that companies entitled to the benefits under the Preferred Enterprise Regime and located in the preferred area A shall be subject to 7.5 percent corporate tax instead of 9 percent as of 2017.

However, a more significant amendment is the implementation of a new tax regime named "Preferred Technological Enterprise," the purpose of which is to further encourage capital investments in Israel by encouraging the expansion of IP-based activities of high-tech companies in Israel. Under this regime, companies meeting the requirements of the amendment relating to, among other factors, their investment in research and development in Israel and the number of employees, shall be subject to lower tax rates for their activities in Israel: 12 percent on revenue attributable to intellectual property and to 7.5 percent if the preferred technological enterprise is located in area "A." The new regime also provides that if the preferred technological enterprise is party to a multinational group that exceeds total consolidated annual revenue of 10 billion shekel (special preferred technological enterprise) the enterprise will be subject to 6 percent corporate tax, regardless of its geographic location.

Furthermore, the Budget Law provides that a sale of intellectual property to a foreign affiliate company, meeting certain criteria, will be subject to a reduced capital gain tax rate of 12 percent, for preferred technological enterprises and 6 percent if the sale is of a special preferred technological enterprise. Additionally, withholding tax on dividends from these revenues to foreign companies will decrease from 20 percent to 4 percent if the foreign company holds at least 90 percent of the preferred technological enterprise's shares.

II. Additional Legislative and Administrative Changes Expected to be Adopted in 2017

A. Tax-Free Reorganizations

The current Chapter E2 of the ITO establishes the terms and conditions for tax-free restructuring, such as transfer of assets between related entities, mergers and split-offs. In general, according to the current law, tax-free reorganization requires that the economic identity of the shareholders will be mostly preserved and that no realization of assets shall occur during a period of two years. According to the current Chapter E2, under certain conditions, a dilution of only up to 49 percent is allowed.

The current limitations associated with restructurings make it difficult for companies to expand their business or to raise capital. As a result, policymakers have come to realize that an adequate solution that is compatible with the demands of the modern economic environment must be found. The first step was taken in April 2016, when the scope of Chapter E2 was expanded to include tax-free restructurings of registered partnerships as well.

Another step was taken in June 2016 when a new draft bill amendment to Chapter E2 of the ITO was proposed ("Draft Bill"). The purpose of the Draft Bill was to increase the availability of tax-free restructuring and to minimize the conditions and limitations currently imposed on companies and their shareholders. The suggested changes are meant to assist companies to raise capital and attract new investors. If passed, the Draft Bill will allow an increase in the dilution of existing shareholders, to allow cash payments to be made to shareholders during the course of the reorganization, as well as other reliefs. It is expected that the Draft Bill will be approved by the Israeli Parliament during 2017.

B. Transfer Pricing—Implementation of BEPS Action 13 into the Israeli Law

On January 4, 2017 the Israeli Tax Authority ("ITA") proposed to amend the current law dealing with international transactions and to adopt the recommendations of Base Erosion and Profit Shifting ("BEPS") Action 13 "Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting" ("Proposed Amendment"). The Proposed Amendment contains the basic elements to be considered in the framework of a transfer pricing analysis based on the principles and recommendations of Action 13.

According to the Proposed Amendment, taxpayers that are a party to a multinational entity ("MNE") with a turnover of transactions exceeding 3.4 billion shekel (which is approximately 750 million euros as was recommended by the OECD) and whose ultimate parent company is located in Israel, shall be required to prepare and file a Country-by-Country Report ("CbCR") of MNEs together with additional information pertaining to foreign companies, which are a party to the MNE. Thus, as part of the Proposed Amendment, information with respect to other entities with which such entities conduct their business will be included.

On January 9, 2017 the Israeli Parliament approved the Proposed Amendment in a first reading and the Proposed Amended is currently being prepared by the Finance Committee of the Parliament for the second and third readings.

C. Digital Economy—Implementation of BEPS Action 1

In April 2016, following the publication of the BEPS report, the ITA published a tax circular addressing the taxation of foreign entities that operate in Israel via the internet. The circular specifies the circumstances in which a foreign entity might be treated as having a permanent establishment ("PE") in Israel and thus subject to tax in Israel. The Circular goes beyond the provision of any tax treaty that Israel is a party to and determines that a foreign entity that has a "significant digital presence" in Israel might be regarded as having a PE in Israel. The circular provides certain examples for this new concept, such as a significant number of Israeli customers using the services of the foreign entity or the online services, which are tailored specifically to Israeli customers. The circular also imposes reporting requirements on online businesses operating in Israel and briefly deals with certain VAT repercussions.

In addition, around the time of the Circular's publication, a new bill to amend the VAT law was proposed to reflect the recommendations of Action 1. Under the proposed legislative amendment, non-Israeli residents providing certain digital services will be required to be registered in a VAT registry, levy Israeli VAT on "digital services" and remit such VAT to the Israeli VAT authorities. This bill is still waiting for the Israeli Parliament approval.

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