Israel

Tax Lawyers Warn of 'Trap' in Israeli Deemed Distribution Rules

By Matthew Kalman

An Israel Tax Authority circular seeking to clarify recent amendments to the law on enacted deemed distribution has resulted in starkly differing interpretations.

Some practitioners warn that multinationals could be liable to tax on loans to Israeli subsidiaries, while others disagree.

Snapshot

- Practitioners find unexpected taxes on inter-company loans and guarantees
- Tax Authority dismisses claim that rules go beyond legislators' intentions

A loan from an Israeli company to its 10 percent or more shareholders or to their related parties, outstanding for a given period of time, is deemed to have been distributed to these shareholders for tax purposes, according to Israeli Income Tax Ordinance section 3(i1), enacted on Dec. 29, 2016, and effective Jan. 1, 2017.

Tax Authority circular 07/2017 of Aug. 23 interprets this law "in a draconian manner" that "requires proper attention by multinational taxpayers with Israeli subsidiaries that extend intercompany loans or guarantees," according to a note published on Oct. 3 by tax lawyers Yuval Navot and Ronen Avner of Herzog Fox and Neeman in Tel Aviv.

"The legislation was originally targeted to individual controlling shareholders, not companies and our (perhaps naive) hope was that the circular would clarify that this is in fact the way the tax authority sees the legislation. Well, that is not the case. The circular only notes that the legislation will not apply to shareholders that are Israeli companies. Non-Israeli corporate shareholders are still in," wrote Navot and Avner, noting also that "guarantees are viewed, under the new rules, as actual loans."

Conflicting Characterizations

"The new deemed dividend rule may result in conflicting characterizations of a loan from an Israeli subsidiary to a non-Israeli shareholder or affiliate. Israel may view the loan as giving rise to a deemed dividend, while the residence state of the corporate shareholder or affiliate may very likely view the loan simply as a loan," Navot and Avner wrote. "Such mismatches are, of course, a good recipe to tax traps, particularly around availability of foreign tax credits."

The circular was issued toward the end of a nine-month period in which service companies, used by individuals paying higher rates of tax to channel earnings, were effectively given a corporate tax reduction to 25 percent from 33 percent to encourage them to distribute accrued profits or transform long-term loans that would be regarded as dividends under the 2016 legislation.

"The idea of the law was to address the situation of individual shareholders owning companies. The way the law was drafted was broader than that. It included any shareholder. It did not limit itself to individual shareholders. The hope was that the circular would really clarify that the law applies to individuals and the tax authority would not enforce it for companies," Navot told Bloomberg Tax Oct. 24. "The circular did exclude companies, but only Israeli companies."

According to the circular, guarantees are also regarded as loans, and are therefore taxable if not repaid by the end of the year following the one when the guarantee or loan is given, Navot said.

"For the future it will have an effect," on the flexibility with which multinationals can finance deals involving Israeli subsidiaries, he said. "You'll see more debt, more capital notes, maybe there will be more limitations on pledges by Israeli companies, the way you see in the U.S. that they can pledge only two-thirds of the stock or the assets."

'Huge Mismatch'

"There was a huge mismatch between the policy and intentions and the actual wording and drafting" of the law, which the circular has exacerbated, said Daniel Paserman, an attorney and CPA and head of tax at Gornitzky & Co. law firm in Tel Aviv. "We are struggling now trying to understand the application of the legislation in these cases."

"I'm doing a very big deal now for a very big fund that is using such financing and we're having a whole big discussion whether this legislation applies or not. Originally, there was no intention to catch these cases, but the law is law, and suddenly there is a problem," Paserman said.

"Any leveraged buyout, any leveraged investment to Israel, there is a question whether this issue is applicable or not. I had three conference calls this week on three different investment deals with three different U.S. multinationals and the same issue arises," he said. On one transaction involving a "multi-billion-dollar fund" in the U.S., "we started the conversation this week and after half an hour they said, 'Oops, we understand we have a big problem. We have to go back to the start and see whether we are going for this transaction or not.'"

Individual v. Corporate Loan Recipients

But Henriette Fuchs, international tax partner at Pearl Cohen Zedek Latzer Baratz in Tel Aviv, said she "absolutely" disagreed with her colleagues' understanding of the circular.

"The circular clearly makes a differentiation between a corporate recipient of a loan and an individual recipient of a loan in a company under its control," Fuchs told Bloomberg Tax Oct. 25

"I don't agree with Herzog's stance," she said. "I think this circular, if you read it well, doesn't aim to say at all that the foreign recipient of a loan who is also a substantial shareholder in a company is now in trouble. That's not what it says. The opposite is true."

But she shared her colleagues' concerns regarding the possible effect on foreign individuals.

"There are some territoriality issues," she said. "If I'm a foreign shareholder it's more complicated because treaties don't say that the Israeli tax authorities can attribute income to a foreign shareholder which wasn't really paid."

"The Israeli tax authorities will have some issues to overcome before they can attribute a dividend distribution also under international tax law to a foreign resident," she said. "If they apply a withholding tax – and I think you can read the law in such a way that the company might have to – then it's very problematic for a foreign shareholder because whatever tax is charged at source by the company, a foreign shareholder can only offset if the country where he lives will also recognize an income and a tax on income with him for that loan receipt."

Tax Authority's Position

"The provisions of section 3 (i1) apply in some cases also to companies, not just individuals, including foreign companies," an Israel Tax Authority spokesperson said in an email to Bloomberg Tax Oct. 30.

"The purpose of the legislation was, among other things, to prevent situations in which taxable shareholders would have actually distributed a dividend, would withdraw the company's money without determining an actual dividend event, so that they would 'enjoy' the company's funds without paying tax," he told Bloomberg Tax. "This is relevant insofar as the shareholder is taxable for the distribution of a dividend, such as foreign companies (and not just individuals)."

"The provisions of the section do not change anything," in respect to dividends between two Israeli companies, which remain untaxed. "For Israeli companies that hold foreign companies so that the dividend is taxable, the provisions of the section are relevant. Similarly, a foreign company that holds an Israeli company."

"Insofar as tax is deducted at source by the Israeli company due to the distribution of a dividend, the receiving company will be issued a tax withholding certificate," he said, dismissing claims that the new rules could clash with international agreements. "According to our position, there is no contradiction in the definition of a dividend according to the tax treaties."

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