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Israel's Take on BEPS Action 1: Taxing the Digital Economy

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In April 2016, the Israeli Tax Authority published a tax circular (the "Circular") addressing the taxation of foreign entities that operate in Israel via the internet. The following article considers the Circular's tax treatment of foreign entities, operating in Israel via the internet.

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I. Digital Economy

In recent years, there has been a substantial worldwide growth in the digital economy. The internet has largely become an international key platform for commerce and service delivery. The sale of products and the provision of services are done remotely (online or through remote servers and "clouds" located elsewhere), without an actual physical presence in the country in which the consumer is located.

The digital economy raises fascinating and complex challenges with regard to tax collection. The classic models of taxation and internationally accepted tax principles, such as territorial or personal tax regimes or the permanent establishment concept provided under tax treaties, may turn out to be irrelevant in the era of digital economy. In many cases, tax laws and tax treaties were formulated decades ago, prior to the technological revolution, a time when policymakers could not have envisioned that one day trade and services will become virtual. These gaps between the present-day economy and existing legislation create many tax distortions including disproportionately low tax collections in countries with high consumption of products and services.

In October 2015 the Organisation for Economic Co-operation and Development ("OECD") released the

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Base Erosion and Profit Shifting Project ("BEPS") Report ("the Report"), which deals, among other issues, with the challenges derived by the digital economy. The purpose of the Report was to deal with these challenges, inter alia, by coordinating between countries and implementing global norms.

II. The Israeli Tax Authority's Circular

In April 2016, the Israeli Tax Authority ("ITA") published a tax circular ("the Circular"); addressing the taxation of foreign entities that operate in Israel via the internet and providing guidelines to the assessing officers. The ITA did not initiate a comprehensive change in legislation; instead it issued this tax circular, solely dealing with actions performed over the internet. Professional circulars that are published by the ITA are nonbinding towards taxpayers, yet they serve as a "safe harbor" for those that act according to the relevant recommendations of the circular. In any case it is foreseen that the publication of the Circular will cause the ITA to be more active vis-a-vis foreign entities with business activity in Israel carried out via the internet.

The Circular opens by acknowledging the changes taking place in the global economy and the expansion of business activity via the internet. It emphasizes that today more foreign entities sell products and provide services to Israeli clients over the internet either directly or with the assistance of affiliated Israeli companies, representatives or subcontractors, who are engaged in marking of the business or its technical support.

The guidelines provided in the Circular distinguish between foreign entities residing in a country that has a tax treaty with Israel ("Treaty Country") and entities residing in a country that does not have a tax treaty with Israel ("Non-Treaty Country"). The Circular also imposes reporting requirements on online businesses operating in Israel and briefly deals with certain VAT matters. The following briefly describes the main issues presented in the Circular.

III. When are Foreign Entities Subject to Israeli Tax?

In general, according to Israeli tax law, business income of a foreign entity is subject to tax in Israel only if the income is generated in Israel. The Israeli Tax Ordinance ("ITO") provides that income is considered to be produced or generated in Israel only if the business activity itself is carried out in Israel. However, Israeli tax would be levied if the relevant foreign entity is a resident of a Treaty Country only if it has a permanent establishment ("PE") in Israel. The OECD Model Tax Convention, which is the basis for most of the recent tax treaties to which Israel is party, provides that a PE may arise under two circumstances: (i) the business activity is conducted through a fixed place of business at the disposal of the foreign entity; or (ii) the business activity is conducted through a dependent agent that has the authority to, and habitually concludes, contracts on behalf of the foreign entity.

When dealing with online transactions, Israeli common practice has been that a fixed place of business is determined according to the location of the servers. However, according to the Circular, existing practice does not coincide with the Report's recommendations and does not correlate with today's economy. Today, many foreign entities conduct their business and approach Israeli customers via a website designed in Hebrew; however, they choose to locate the server outside of Israel. In view of this, according to the Circular, when determining the existence of a PE, less importance should be attributed to the location of the server; in this era of digital economy the server may be located anywhere in the world whilst the various marketing, support and development activities may be located elsewhere. These changes require modification of the current rules.

IV. Business Activity in Israel of a Foreign Tax Resident Entity from a Treaty Country

A. Alternative I—Fixed Place of Business of the Foreign Entity

The foreign entity may perform its online business activities through a fixed place of business in Israel. When the foreign entity has a branch, an office or any other facility in Israel used by the foreign entity to conduct its business, this can be treated as a PE in Israel. Additionally, the Circular determined that when the representatives and employees of the foreign entity make use of an Israeli office of a related party that is considered an Israeli tax resident, the ITA may regard it as a PE of the foreign entity.

It is important to note that the OECD Model Convention provides some exceptions; in general, an activity of a preparatory and auxiliary nature does not constitute a PE. Such activity may include the use of facilities for storage of goods, exhibitions, delivery or use of facilities for the purpose of collecting information or purchase of goods.

The Circular notes that the unique feature of business activity conducted via the internet may establish a PE, emphasizing that if, in addition to the preparatory and auxiliary activity performed in the facility, another business activity of the foreign entity takes place, such facility shall be treated as a fixed place of business, and thus constitute a PE for all the activities of the foreign entity. According to the Circular the following activities which take place alongside the preparatory and auxiliary activity of the foreign entity may be treated as constituting a PE for the foreign entity: (i) identifying potential clients and marketing activities; (ii) management of the relationship with the Israeli customer including organizing conferences, exhibiting new products, gathering information on the Israeli market and so on.

The above was already an existing practice for the most part, but the Circular introduced a new aspect in providing that, what was treated in the past as a preparatory and auxiliary activity only may, in the digital era, be treated as a business activity which constitutes a PE for a foreign entity if the foreign entity has a *significant digital presence* in Israel. The Circular provides some criteria for such significant digital presence:

(i) a significant number of contracts for providing digital services was signed with Israeli residents over the internet,

(ii) a significant number of customers in Israel uses the foreign entity's services via the internet, or

(iii) the online service is tailored to Israeli customers, i.e., the charge for the services is in local currency or the service provider is able to clear Israeli credit cards and so forth.

B. Alternative II—Dependent Agent

Another alternative as to when a foreign entity might be deemed to have a PE according to the OECD Model Tax Convention is when a foreign entity has a dependent agent in the other country, i.e. a person that has the authority to bind the foreign entity in contracts and habitually exercises such authority. The Circular provides that even when a dependent agent does not sign the contract itself but performs all the required activities for the foreign entity to sign the contract, such person might be treated as a dependent agent and as such constitute a PE for the foreign entity.

The Circular provides a list of situations whereby an Israeli agent acting on behalf of the foreign entity may lead to a PE of the foreign entity in Israel. These include the following: (i) lack of involvement on the foreign entity's part; (ii) orders placed by the Israeli agent are routinely approved by the foreign entity; (iii) the Israeli agent has the authority to set the commercial terms and the price; (iv) there is significant involvement of the Israeli agent in the adjustment of the contract to the needs and requirements of the Israeli customer; or (v) the Israeli agent is a party to a contract between the foreign entity and the Israeli client.

V. Business Activity in Israel of a Foreign Tax Resident Entity from a Non-Treaty Country

When the foreign entity is a resident of a Non-Treaty Country, it is subject to tax in Israel if the business activity is carried out in Israel. The Circular provides that with respect to digital economy, a business activity is carried out in Israel if (i) the business activity is carried out via a fixed place of business, (ii) if the business activity is carried out via the assistance of an agent in Israel, or (iii) if there is a *significant economic presence* of the foreign entity in Israel. The Circular establishes once again that if the online activity is also supported by the existence of a physical location or a representation in Israel, including a related entity or branch, such an activity should be considered as one carried out in Israel.

As to the first alternative, the Circular provides that when the foreign entity has a physical presence in Israel, the foreign entity shall be treated as having a PE in Israel. Physical presence includes, *inter alia*, offices or facilities for preparatory or auxiliary activities of the foreign entity as well as engaging employees or having a facility where it provides services for the Israeli customer or has a branch in Israel.

As to the second alternative, the Circular provides a list of events in which the activity of a local agent including an Israeli-related entity might be treated as a business activity, carried out in Israel, of the foreign entity with a business activity via the internet: (i) when representatives of the foreign entity are involved in lead generation or in gathering information or assistance through a representative in Israel, or (ii) if there are ongoing activities between the representatives of the foreign entity and the Israeli customers in terms of customer relations, such as the organization of conferences for customers, creating opportunities to display products, development and improvement of the service provided to the customers, provision of feedback with respect to the activities of a foreign entity in the domestic market and so on, and (iii) if the services provided including marketing, billing, support, consulting are partially or fully provided by an Israeli agent.

The third alternative, introduced by the ITA, is an innovation of the ITA in determining what shall be treated as business activities of the foreign entities in Israel and provides that even if the foreign entity does not have a physical presence in Israel, it does, however, have a *significant economic presence* in Israel, and thus such activity shall be treated according to the Circular as business activity carried out in Israel. In this regard the Circular provides a list of criteria of when an activity is to be deemed as having a *significant economic presence*:

(i) the foreign entity provides internet services to customers, including advertising, brokerage, marketing, support etc. with respect to Israeli clients,

(ii) the foreign entity has a significant number of transactions with Israeli customers via the internet,

(iii) the foreign entity provides services to Israeli customers via the internet and the platform is tailored for Israeli clients (for example the website is in Hebrew, the website has local advertisements, the charge for the services is in local currency etc.),

(iv) the services provided by the foreign entity are consumed by many Israeli customers via the internet and

(v) there is a strong connection between the remuneration paid to the foreign entity and the extent of use by Israeli customers.

VI. Attribution of Income

A. Foreign Tax Resident Entity from a Treaty Country

If a foreign entity from a Treaty Country is deemed to have a PE in Israel, its income and profits shall be attributed to said activity. The Circular provides that attribution of income to a PE shall be done according to the Authorized OECD Approach ("AOA") that was presented in the 2010 OECD report on the attribution of profits, and is based on the arm's length principle. Hence, the functions, assets and risks of the activity in Israel should be analyzed.

B. Foreign Tax Resident Entity from a Non-Treaty Country

However, when the foreign enterprise is from a Non-Treaty country, the Circular provides little guidance regarding the attribution of profits, saying only that the attribution shall be based on the examination of the functions, assets and risk of the activity carried

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out in Israel ("FAR") without referring to any specific attribution approach.

VI. Reporting Requirements

The Circular imposes reporting requirements on foreign entities which are treated as having a PE in Israel or in cases of foreign entities from a Non-Treaty Country who have a business activity in Israel in respect of profits attributed to the PE or to such activity in Israel.

Moreover, according to the Circular, in order to examine whether the foreign entity has a PE or a business activity in Israel the ITA has unlimited authority to require any information and documentation from the foreign entity and its affiliates, regarding their activity in Israel. In this regard, it should be noted that it is questionable whether the ITA has indeed such broad authority.

VIII. Value Added Tax

The Circular also refers to Value Added Tax ("VAT") implications on foreign entities providing services via the internet to Israeli customers.

According to Israeli VAT law, a service is to be treated as a "deal" in Israel if it meets one of the following requirements: (i) the services are provided by a person who conducts business activity in Israel, (ii) the services are provided to Israeli customers or (iii) the services are provided with respect to an Israeli asset. According to Israeli VAT law, if the service is provided by a foreign resident, in general the liability to pay the VAT lies on the person who receives the services, i.e. the Israeli customer (unless the person providing the services is a "dealer" for VAT purposes). However if the foreign service provider has a business activity in Israel, it is required by the VAT law to register in Israel as a "dealer" for VAT purposes and report (including issuing of an invoice) and pay the VAT on such deals. Moreover, such a service provider, who is regarded as an Israeli "dealer" must appoint a local representative in Israel.

In this regard, the Circular provides criteria according to which the foreign entity providing services to Israeli customers shall be considered an entity conducting business activity in Israel and as such is required to register as a "dealer" and pay the VAT in Israel: (i) the activity of the foreign entity constitutes a PE for income tax purposes in Israel, (ii) the foreign entity has a business mechanism in Israel; a branch employees, offices or any other physical existence through which it conducts its business activity, (iii) the foreign entity conducts business in Israel with the assistance or collaboration of an Israeli agent, or (iv) the foreign entity has a *significant economic presence* in Israel. The Circular provides under which circumstances the foreign entity shall be treated as having a significant economic presence in Israel, and as such shall be required to register as a "dealer": if the foreign entity (i) provides services to Israeli customers via the internet which include advertising, brokerage, marketing, support and etc., (ii) has a significant number of transactions with Israeli customers via the internet, (iii) provides services via the internet to Israeli customers and the platform is tailored for Israeli clients, (iv) the services provided via the internet by the foreign entity are used by many Israelis and (v) there is a strong connection between the remuneration paid to the foreign entity and the extent of use by the Israeli customers.

In addition to the Circular, it should be mentioned that in March 2016 (a few days before the publication of the Circular), the Israeli Ministry of Finance published a draft bill to amend the VAT law according to similar concepts that were also presented in the Circular. If the bill is passed, it will require nonresident suppliers of digital services to register and account for VAT in Israel, as suggested in the Circular.

IX. Conclusion

It seems that the ITA is attempting to be a world pioneer in drafting domestic guidelines for implementing the BEPS recommendations and address the tax challenges brought about by the digital economy. There is no doubt that a major change has been set in motion for the foreign entities operating via the internet and therefore these entities should make proper arrangements.

It should be noted that following the publication of the Circular, the ITA is already implementing the guidelines of the Circular with respect to the activity of foreign digital technology companies in Israel. Not only that, the ITA has implementing the guidelines of the Circular even beyond the spectrum of the Circular; including implementation of the guidelines on all type of foreign entities, even those entities that are not operating in Israel via the internet.

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