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LLC Classification from an Israeli Tax Perspective

Many Israeli investors choose to invest in the US through Limited Liability Corporations (LLC). One of the advantages of using LLCs is the option for such a corporation to be treated for US tax purposes as a pass-through entity under the US “Check the Box” regulations. Thus, from a US tax perspective, the LLC’s taxable income is regarded as the income of the entity’s interest holders, therefore resulting in a one level of taxation. In cases where the interest holders of the LLC are individuals, the income will be taxed in the US as if it were derived by an individual shareholder, including reduced tax rates on long term capital gains.

From an Israeli tax perspective, the taxation of Israeli interest holders in an LLC which is treated as a pass-through entity for US tax purposes is neither regulated nor clear. There is lack of certainty regarding the question of whether a US LLC should be regarded as a flow-through entity (and accordingly tax the shareholders) or as an opaque entity (in which case the LLC will be taxed on its own taxable income, and the shareholders will be taxed on the profit distribution from the LLC). In the past, the Israeli Tax Authority (“ITA”) published a number of circulars and rulings on this matter, but there have been no legislation or specific court rulings to regulate the matter in a comprehensive and coherent manner.

Recently, the Israel District Court published its ruling in **the case of Yaacov Harel V. Dan Region Income Tax Assessor Officer**, which sheds some light and elaborates on the taxation in Israel of a US LLC, which is regarded as a pass-through entity from a US tax perspective.

In this case, an Israeli taxpayer indirectly held the rights in a US LLC, which was taxed as a flow-through entity in the US. The LLC had business income originating in the US and the LLC distributed funds to the Israeli shareholder for which US tax was withheld.

In the above case, the court established a number of fundamental determinations:

1. The classification of a foreign corporation with respect to its taxation in Israel shall be in accordance with the tax laws in Israel. Meaning, even in cases where a corporation is regarded as a pass-through entity in another country, it may be treated as an opaque entity from an Israeli tax perspective.

2. Examination of the characteristics of the US LLC according to Israeli tax laws results in the conclusion that it does not meet the conditions required by the Israeli Income Tax Ordinance for the purpose of treating the LLC as a transparent entity. Therefore, a US LLC will be taxed in Israel as an opaque entity, despite its classification for US purposes as a flow-through entity.

3. The tax method in Israel that applies to corporations is the two-level taxation method, which imposes corporate tax on the corporation's taxable income, and tax on the dividend received by the shareholder upon distribution of profits from the corporation. Thus, the effective tax rate up to the individual level may reach 50%. Such effective tax rates in Israel shall apply as well with respect to US LLCs, even if treated in the US as pass-through entities.

4. The court addresses circular no. 5/2004 published by the Israeli Tax Authority on the issue of a foreign tax credit to an Israeli tax resident holding interests in an LLC. The circular allows an Israeli taxpayer who holds interests in a US LLC, which is treated in the US as a pass-through entity, to attribute the LLC's taxable income to the Israeli interest holder, only for the purpose of allowing the shareholder to receive a tax credit in Israel for taxes paid in the US. However, the circular explicitly states that it is limited only to foreign tax credit, and does not regard the LLC as a flow-through entity for all tax purposes. The court emphasized that losses of the LLC are not attributed to its shareholders

In the above court case, the taxpayer chose <u>not</u> to regard the LLC as a transparent entity for tax purposes in Israel, in accordance with circular no. 5/2004 since such a choice would have led to a worse tax result. Thus, the LLC had income from business originating in the US, and therefore the effective tax rate in Israel up to the level of the individual shareholder should be up to 50%.

It should be noted that in the event that an Israeli individual (or his immediate family members) holds all of the rights in a US LLC, a solution to the issue may be to choose to regard the LLC for tax purposes in Israel as a Family Company. Such a company is considered a transparent entity for Israeli tax purposes, and thus both in Israel and in the United States the LLC will be taxed as a transparent entity, eliminating the mismatch between both jurisdictions.

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