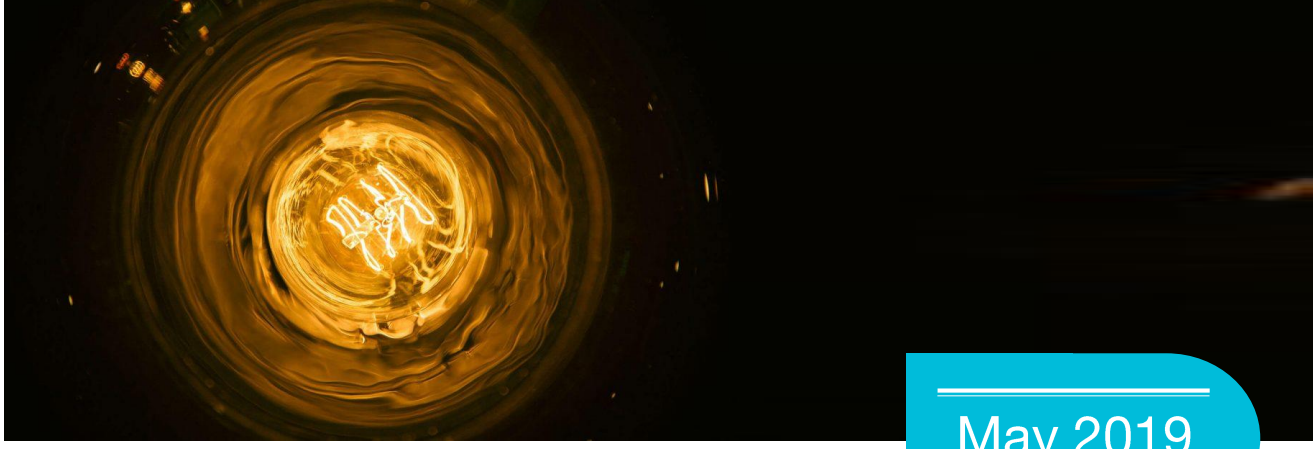

May 2019

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Israeli CFC Rules Apply to Foreign Real Estate Companies Controlled by Israeli Shareholders

Recently, the Supreme Court published the judgment in the matter of **Tax Assessor for Large Enterprises v. Rosebud**, which deals with the matter of the interpretation of the provisions of Section 75B of the Israeli Income Tax Ordinance (the "**Ordinance**"), with respect to a controlled foreign corporation (CFC). In the judgment, the supreme Court overturned the decision of the District Court (see our bulletin with respect to the District Court judgment) in a decision that is likely to have implications for the activities of Israeli taxpayers outside of Israel, through foreign companies in their control, and in particular, for companies that invest in real estate outside of Israel.

In January 2003, a comprehensive reform in the Israeli tax laws was introduced, by adopting, *inter alia*, the personal tax system instead of the territorial tax system, which had been in effect prior to the reform. According to the personal tax system, an Israeli resident for tax purposes is subject to tax in Israel on her worldwide income. In addition, the tax legislature set forth a number of anti-avoidance provisions, which were intended to prevent tax avoidance by setting up foreign companies, while taking advantage of the personal nature of the Israeli law. The main anti-avoidance provision in this regard is the application of a controlled foreign corporation (CFC) regime, which is set forth in Section 75B of the Ordinance. This section determines that an Israeli resident, who is a controlling shareholder of a controlled foreign corporation, which has passive income that has not been distributed as a dividend, will be deemed to have received, each year, his pro rata share of the said profits as a "deemed dividend".

A controlled foreign corporation is a private company, which is a foreign resident for tax purposes, that is controlled by Israeli residents, where most of its income or profits is derived from passive income and where the rate of tax thereupon in the foreign country does not exceed 15%. Passive income includes interest income, income from linkage differentials, dividends, royalties, rent and proceeds from the sale of an asset, provided that such income does not qualify as business income.

In the case at hand, Rosebud (an Israeli subsidiary of an Israeli traded public company) ("**Rosebud**") indirectly held, through a Dutch company, a number of companies in Luxembourg, which held other foreign companies, each holding a real estate asset separately. This holding structure, in which each company holds one asset only, is a common structure in the real estate sector. This structure has many business advantages, which do not arise from tax considerations, including: (i) limitation of liability; (ii) financial benefits; (iii) the possibility of selling assets separately – whether directly or through the sale of shares.

In the case at hand, assets and shares were sold, and Rosebud claimed that the provisions of Section 75B of the Ordinance does not apply, because the matter concerns business income, which is not passive income. Thus, the question arose as to whether the sale of a single asset by a company or the sale of shares of a company constitutes a capital event, which creates a passive profit, for the purposes of the provisions of Section 75B. Rosebud argued that its activity should be examined as a whole, and that the Group's operations, which include the development, management, appreciation, rent and disposal of real estate assets amount to business activity. Therefore, selling a particular asset out of a wide portfolio should be classified as business income rather than capital gain. In that case, the income is not subject to the CFC provisions, even though, in each transaction, only one single asset was sold or shares of one single company.

The Israel Tax Authority, on the other hand, claimed that it is necessary to examine each corporation (asset) separately, without looking at the group of companies as a whole. This has been the position of the Israel Tax Authority since the CFC legislation was introduced, in 2003.

The District Court allowed the Company's position, in contrast to the position of the Israel Tax Authority, and ruled that the group's operation should be examined as one business operation. Consequently, the Israel Tax Authority filed an appeal with the Supreme Court.

The Supreme Court in an extremely short judgment, ruled that the District Court had departed from the fundamental principle in the taxation of companies in Israel, whereby each company is a separate tax unit. Thus the Supreme Court classified the income as passive, and ruled that the CFC apply.

Beyond this ruling, the Court did not go into an in-depth analysis of the issue, because the involved companies were insolvent, and therefore, there was no fiscal benefit to the appeal. Notwithstanding the background and the exceptional circumstances, and notwithstanding the lack of a thorough reasoning of the issue, the ruling from the judgment is, *prima facie*, as stated above, that each company should be examined separately, as a separate tax unit.

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