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2020, More than just COVID

Daniel Paserman looks at the Israeli tax developments of 2020.

The following article presents some of the significant developments in Israeli tax during the last year.

UPDATES IN THE HIGH-TECH INDUSTRY

The Broadcom Case – Business Model Change

One of the most significant judgments published in recent years, which is highly relevant for the high-tech industry, is the **Broadcom** case. Multinational companies acquire Israeli companies almost on a weekly basis. Following such acquisition, the acquired Israeli company is usually transformed into an R&D center, compensated on a cost-plus basis.

That was also the case with Broadcom. Broadcom purchased the Israeli target company at a value of approximately 200 million USD. Following the acquisition of its shares, the Israeli company engaged in three inter-company agreements with the group and became an R&D center.

According to the Israeli Tax Authority ("**ITA**"), after the acquisition, the Israeli company underwent a "business model change", from a business venture that owns independent profitable intellectual property to a "risk-free" company that operates using a cost-plus model and develops intellectual property in favor of related foreign companies. Therefore, it should have been considered as an "empty corporate shell" that "emptied out" its assets in favor of the group's members. Hence, the transaction should be reclassified, so that the company shall be taxed for the sale of its "FAR" (Functions, Assets and Risk). The FAR should be valued based on the price of the previous share purchase transaction, subject to a few minor computational adjustments.

However, the court rejected the ITA's thesis and accepted the appeal. The case was conducted by our firm and the ITA did not file an appeal to the Supreme Court.

The district court determined that "*I do not believe that the words "business model change" are some kind of magic words, where it is sufficient simply to utter them in order to give rise to a change of the classification of the transaction that was made between the parties*". The district court firmly stated that a "business model change" is a legitimate business action and not an automatic cause for issuing a sale assessment. This is a warning sign for the ITA which has been repeatedly reciting these three words, claiming that whenever an Israeli company acquired by an international group and shifts its model business to a "cost-plus" model, it transfers its own "FAR". Now, the ITA is committed to carefully reviewing every transaction.

Profit Split Assessments

After losing the Broadcom case, it seems that the ITA has changed its approach towards multinational companies. Instead of claiming for a business model change after an acquisition of an Israeli company, now the ITA claims in many cases the opposite. Meaning, the ITA claims that the acquired Israeli company is independent and generates a substantial contribution to the multinational group. The ITA argues that the Israeli company is highly significant,

serves critical functions in the group of companies, employs key personnel in the global group and bears significant risks. Thus, according to the ITA, the Israeli company should be regarded as managing and controlling the risks, and therefore some of the global group's profits should be attributed to it.

In other words, the ITA claims that more profits should be attributed to Israel compared to the global profits. Therefore, the "profit split method" should be applied with regard to transfer pricing, rather than the "cost-plus method".

Accordingly, the ITA has recently started to issue "profit spilt" assessments. The ITA analyzes the Israeli company's contribution to the entire multinational group and its FAR. After doing so, the ITA tends to claim that some of the multinational group's profits should be attributed to Israel.

Our firm has been representing clients before the ITA and in court concerning such assessments.

Capital Gain Treatment for Shares Issued Under Section 102

Section 102 of the Israeli Income Tax Ordinance ("**Section 102**" and the "**ITO**", respectively) allows Israeli residents who are employees of a company to receive, under certain conditions, favorable tax treatment for compensation in the form of equity awards. Section 102 provides beneficial tax treatment to the employees: first, it allows for a postponement of the taxable event for the employee. Second, employees of private companies enjoy a 25% tax rate rather than marginal tax rate (which can be up to 50%).

A precedential district court ruling, **Shohat v. Tsfat Tax Assessor**, illuminates the various aspects of Israeli employee option plans under Section 102, including, *inter alia*:

- *The Nature of the ITA's Preliminary Approval of the Option Plan:* a company must antecedently file the option plan and receive the ITA's approval that the plan satisfies Section 102's requirements. An option plan would be approved if the ITA failed to reject it within 90 days from its filing.
- *More Flexibility in Designing Option Plans:* the Court concluded that companies have the prerogative to determine which rights are attached to each class of shares, including its transferability.
- *The Classification of a "Controlling Shareholder":* to qualify for beneficial tax treatment, an employee should not hold 10 percent or more of the company's share capital ("controlling shareholder"). The Court determined that "controlling shareholder" holdings should not be determined per class of shares, but rather by the total issued shares.
- The employee should be taxed at a 25% rate as a capital gain pursuant to Section 102 also in cases where the distributing company enjoys a beneficial tax treatment under the Israeli Encouragement of Capital Investment Law.

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The district court determined that *"I do not believe that the words "business model change" are some kind of magic words, where it is sufficient simply to utter them in order to give rise to a change of the classification of the transaction that was made between the parties."*

It should be noted that both the taxpayer and the ITA recently appealed this judgement.

Amending the Angels Law

Recently, an initial draft of the economic plan, which incorporates changes that the government intends to promote regarding various sectors, was published. One change aims to promote the growth of the Israeli high-tech industry by removing funding barriers and encouraging the growth of Israeli companies whose intangible assets are in Israel and whose center of activity is based in Israel (the "**New Proposal**").

The New Proposal aims to amend the "Angels Law" (enacted in 2011) as follows:

- Simplifying the bureaucratic process, so that the required approvals and confirmations from the Innovation Authority and the company's accountants will no longer be required.

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- Allowing a deferral of capital gains tax generated from the sale of the investment in the high-tech company, provided that the investor made another investment in an early stage company within 12 months of the realization of the first investment.
- Eliminating the requirement to maintain the purchaser and the target as two separate entities and allow for their merging.
- Extending the tax benefits also to the acquisition of foreign high-tech companies provided that the intellectual property of the purchased target should be transferred to Israel, under certain conditions.
- Exempting interest on loans granted by a foreign financial institution to companies that meet certain conditions.

PRIVATE CLIENTS DEVELOPMENTS

Groundbreaking Expected Reform in International Taxation

The ITA is currently planning a major International Tax Reform (the "**Reform**"), which may have great influence on individuals with economic or personal ties to Israel. Moreover, it may influence foreign residents considering moving to Israel, Israeli residents considering leaving Israel and Israeli residents with households both in Israel and abroad. Key components of the Reform include:

- *Tax Residency:* Israeli residency for tax purposes is based on the "center of life" test, which examines the overall facts and circumstances of the individual, including one's familial, economic and social ties. In addition, the amount of days spent in Israel is important as the ITO provides two alternative residency rebuttable presumptions: an individual who stays in Israel for more than 183 days in a tax year or more than 425 days over the course of three consecutive tax years (and at least 30 days in the third tax year) is presumed to be an Israeli tax resident. The Reform wishes to introduce stricter irrebuttable presumptions determining one's tax residency, including, inter alia, the following: the individual will be considered an Israeli tax resident if they stay in Israel for more than 183 days for two consecutive tax years; more than 100 days in a tax year and more than 450 days over the course of three consecutive tax years; or more than 100 days in a tax year and their spouse is an Israeli resident.
- *Exit Tax:* an "**Exit Tax**" is imposed on any Israeli tax resident that emigrates from Israel and becomes a foreign tax resident. The "emigrant" is treated as though they had sold all of their assets on the day preceding the day on which they had ceased being an Israeli tax resident. Today, the law allows the taxpayer, however, to postpone the tax payment until the actual realization of the assets. The capital gain attributed to Israel upon the actual sale will be the capital gain generated during the time the "emigrant" was an Israeli tax resident. The Reform wishes to impose in certain circumstance an immediate obligation to pay the exit tax, and to provide

securities in cases that postponement shall still be available. The Reform includes additional reporting obligations and other provisions intended to prevent tax avoidance.

- *Controlled Foreign Company* ("**CFC**"): The Reform attempts to expand the definition of passive income to include certain business income that is received from related parties, as well as lower the passive income threshold for the purpose of classifying a company as a CFC to one third of the total income or profits of the foreign company. Moreover, stricter conditions shall be applied to foreign companies that are residents of a country which is in the "black" or "gray" lists of the EU (excluding treaty countries), or residents of a country with which Israel does not have an agreement that allows the exchange of information. The Reform shall also impose reporting obligations on Israelis holding more than 10% of a foreign company's means of control.
- *Foreign Tax Credit:* The tax credit method in Israel is the "Basket Method" according to which each income item, on which tax was paid outside of Israel, is considered a separate "basket", and the foreign tax will be creditable only against the Israeli tax paid for that specific income. The Reform reduces the number of "baskets" used in in the "Basket Method", denies credit for foreign tax paid in certain cases or in certain countries, and prevents the use of excess credit in the following years, except for in specific cases.
- *Tax Benefits for New Residents:* An individual who has become an Israeli tax resident after 2007, whether for the first time or as a veteran returning resident , is entitled to extensive tax benefits during a period of 10 years (the "**Benefits Period**"), such as exemption from Israeli tax on foreign source income and reporting requirements regarding foreign income and assets. The Reform is expected to limit the tax benefits afforded to new residents, although this matter is still under discussion.

Obligating National Insurance Contributions for Family Company Income

During the last year, the Regional Labor Court of Tel Aviv published a ruling in the case of **Refael Nechushtan**, which determined that individuals are required to make national insurance contributions for all income derived from a "Family Company", irrespective of its source or type, including income that would have been exempted if the individual had incurred it directly (and not through the Family Company).

The National Insurance Law (the "**Law**") provides that required insurance contributions are calculated on the basis of an individual's taxable income defined by the ITO. However, capital gains and income such as income from interest, dividends etc. earned directly by an individual are exempt from insurance contributions ("**Exempt Income**").

The Reform wishes to introduce stricter irrebuttable presumptions determining one's tax residency

According to the ITO, a company whose shareholders are all close family members can choose to be treated as a look-through entity for tax purposes (Family Company). The income and profits of a Family Company are attributed to the shareholder who is entitled to the largest share of the Family Company's profits. The taxation of the company's income is calculated as of the date at which the income is generated by the Family Company and not the date of the distributions to the individual shareholders.

The Regional Labor Court ruled that an individual's exemption from insurance contributions with respect to Exempt Income does not apply to income attributed to the individual from a Family Company. Therefore, all of a Family Company's income should be regarded as having been distributed as a dividend obligated in insurance contributions, irrespective of the type of income.

Unreported Income is Not Covered Under the Statute of Limitations

In a recent case, the district court dismissed a motion to approve a Class Action against the ITA (the **Nukrai** Case), ruling that the civil statute of limitations

period that is set forth in the ITO does not apply to income that has not been reported.

In the course of voluntary disclosure proceedings, the ITA generally collects tax on income that has been generated in the last ten years, and also on the value of the undeclared assets of the taxpayer as it was ten years ago, unless it has been proven that these assets are attributable to income that was not subject to tax or that the tax thereon was duly paid.

The Reform reduces the number of "baskets" used in in the "Basket Method", denies credit for foreign tax paid in certain cases or in certain countries, and prevents the use of excess credit in the following years

In a motion to approve the Class Action, it was claimed that since the criminal limitation period in respect to income tax is ten years, the ITA is precluded from imposing tax on assets that were accumulated more than ten years ago, including in the framework of a voluntary disclosure proceeding.

The Court, however, accepted the ITA's position, ruling that even though there is no dispute that a taxpayer cannot be indicted for concealing income that was generated more than ten years ago, it cannot be established that the tax in respect of such income shouldn't be collected.

While it is true that taxpayers who failed to report their income are subject to statute of limitations for the purpose of the filing of a criminal indictment, nevertheless, in situations in which no report was filed and the income has not been reported at all, it has been determined that there is no restriction on the statute of limitations period from the civil aspect. Therefore, in that case it is possible to demand reports, to issue assessments, and to collect taxes in respect to the above-mentioned income, needless to say, subject to the rule of reasonableness as required of any state authority by administrative law.

ABOUT THE AUTHOR

Daniel Paserman, ADV (CPA) TEP, heads Gornitzky's Tax practice. He is involved in intricate corporate tax planning – both domestic and international. His broad experience includes negotiations with the ITA regarding tax regulatory issues, seeking and obtaining tax rulings for both Israeli and global companies operating in Israel, as well as handling wide-scope tax assessments for both global and Israeli corporations operating in Israel. Daniel represents global companies and leading Israeli corporations in complex tax disputes before various judicial bodies, including the Supreme Court, whilst applying his interdisciplinary approach, vast experience and accounting expertise.

In the field of private clients, Daniel represents clients in matters concerning family wealth planning and preservation, specializing in taxation of trusts and estates and provides tax planning guidance for high net worth individuals. He has earned the trust of highly affluent families and HNWI, serving as their legal advisor and personal consiglieri, and often provides consultation in the area of philanthropy. He also advises new and returning residents who immigrated to Israel with regard to the projected ramifications of such a move on their worldwide assets and business activities.

Daniel serves as the co-chair of Society of Trusts and Estate Practitioners Israel (STEP) and is a lecturer on Corporate & International Taxation at Tel Aviv University. ■