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# Corporate Tax

Law and Practice – Israel

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# ISRAEL

**LAW AND PRACTICE:** p.3

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The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

# Law and Practice

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## CONTENTS

**1. Types of Business Entity, Residence and Tax Treatment p.4**
- 1.1 Corporate Structures and Tax Treatment p.4
- 1.2 Transparent Entities p.4
- 1.3 Determining Residence p.4
- 1.4 Tax Rates p.5

**2. Key Features of the Tax Regime p.5**
- 2.1 Calculation of Taxable Profits p.5
- 2.2 Special Incentives for Technology Investments p.5
- 2.3 Other Special Incentives p.5
- 2.4 Basic Rules on Loss Relief p.5
- 2.5 Limits on Deduction of Interest p.5
- 2.6 Basic Rules on Consolidated Tax Grouping p.6
- 2.7 Capital Gains Taxation p.6
- 2.8 Other Taxes on Transactions p.6
- 2.9 Other Notable Taxes p.6

**3. Division of Tax Base Between Corporations and Non-Corporate Business p.6**
- 3.1 Closely Held Local Businesses p.6
- 3.2 Corporate Rates and Individual Rates p.6
- 3.3 Accumulation Earnings for Investment Purposes p.6
- 3.4 Sales of Shares in Closely Held Corporations p.7
- 3.5 Sales of Shares in Publicly Traded Corporations p.7

**4. Key Features of Taxation of Inbound Investments p.7**
- 4.1 Withholding Taxes p.7
- 4.2 Primary Tax Treaty Countries p.7
- 4.3 Use of Treaty Country Entities by Non-Treaty Country Residents p.7
- 4.4 Transfer Pricing Issues p.8
- 4.5 Related Party Limited Risks Distribution Arrangements p.8
- 4.6 Variation from OECD Standards p.8

**5. Key Features of Taxation of Non-local Corporations p.8**
- 5.1 Taxation of Non-Local Corporation Versus Local Subsidiaries p.8
- 5.2 Capital Gains of Non-Residents p.8
- 5.3 Change of Control Provisions p.8
- 5.4 Determining the Income of Foreign-owned Local Affiliates p.9
- 5.5 Deductions for Payments by Local Affiliates p.9
- 5.6 Contraints on Related Party Borrowing p.9

**6. Key Features of Taxation of Foreign Income of Local Corporations p.9**
- 6.1 Foreign Income of Local Corporations p.9
- 6.2 Non-Deductible Local Expenses p.9
- 6.3 Taxation on Dividends from Foreign Subsidiaries p.9
- 6.4 Use of Tangibles p.9
- 6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules p.9
- 6.6 Rules Related to the Substances of Non-Local Affiliates p.10
- 6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates p.10

**7. Anti-Avoidance p.10**
- 7.1 Overarching Anti-Avoidance Provisions p.10

**8. Other p.10**
- 8.1 Regular Routine Audit Cycle p.10

**Herzog Fox & Neeman** has expertise in all aspects of corporate, commercial and administrative law and serves many of Israel's and the world's best-known companies. HFN's clients are a diverse group operating across a broad spectrum of industries, ranging from small domestic businesses to multinational corporations with operations in Israel. The firm's lawyers – which number over 300 in total - are divided into more than 50 practice groups, each staffed with specialist lawyers. In keeping with the firm's global perspective, the majority of HFN's business is conducted in English and lawyers work closely with leading firms in jurisdictions around the world.

## Authors

**Meir Linzen** has more than 30 years of experience and is regarded as one of Israel's leading tax experts. He specialises in tax issues relating to international mergers and acquisitions in Israel, international and cross-border tax planning for multinational corporations and advising high net-worth individuals in their domestic and international tax and estate matters. He serves as chairman on a number of committees, such as the Tax Committee of the Israeli Bar and the International Committee of the Israeli Bar.

**Guy Katz** is a partner in HFN's tax department. He has more than 18 years of experience as an accountant and a tax lawyer, with particular expertise in personal, corporate and international taxation. Guy advises private clients and high net-worth individuals with respect to cross-border tax issues and trusts, and counsels multinational corporations on the tax implications of their activities in Israel. Over the last few years, Guy has handled more than 300 cases for high net-worth families, settling arrangements with the Israel Tax Authority in respect of assets valued at billions of dollars.

## 1. Types of Business Entity, Residence and Tax Treatment

### 1.1 Corporate Structures and Tax Treatment
Most businesses conducting trade in Israel are incorporated as companies limited by shares, which may be public or private, or as partnerships (for partnerships, please see below). Public company shares are listed on a stock exchange or offered to the public pursuant to a prospectus. A private company is any company other than a public company.

The Israeli corporate tax regime is based on two-tier taxation: first, at the company level, and second, upon dividend distribution, at the shareholder level. Dividend income is subject to a lower tax rate than ordinary income.

### 1.2 Transparent Entities
Transparent entities commonly used include partnerships, which are deemed to be pass-through entities that are not subject to two-tier taxation. Only the partners of the partnership are subject to tax in respect of its income based on the pro rata rights of the partners to the partnership results. Partnerships are widely used in the case of private equity firms and hedge funds.

In a general partnership, each partner is liable for all the partnership's liabilities, as opposed to a limited partnership, in which the limited partners are liable only to the extent of their contribution to the partnership. Limited partnerships must have a general partner, who has unlimited liability. Only the general partner is allowed to participate in the management of the limited partnership.

Additional transparent entities, which are not subject to two-tier taxation and are seen as transparent entities, include house property companies, which are minority companies (controlled by five people or fewer, which meet several other conditions) whose assets and business are holding buildings. Certain family companies may appoint a "representative assessee," who holds the rights to the highest percentage of the company's profits. The taxable income of the company will be attributed to the representative and will not be subject to two-tier taxation.

### 1.3 Determining Residence
A company is considered a resident of Israel if it was incorporated in Israel; or if it is incorporated abroad, if it is managed and controlled from Israel. According to Israel Tax Authority (ITA) guidance, a company is managed and controlled in the place where the business strategy of the company is determined, where, as a factual matter, the main business decisions of the company are made. The location of the board of directors meetings is an important, although not determinative, factor, especially where the board author-

ises another organ of the company to manage the company. In a 2012 Supreme Court case, the managers of a foreign company acted as an artificial platform for conducting the business of the Israeli company and were not substantially involved in the business management of the foreign company. The Court ruled that the foreign company was to be regarded as having been managed and controlled from Israel.

Transparent entities are not considered to be residents of Israel for treaty purposes and are usually eligible to treaty benefits based on the residency of the interest holder.

### 1.4 Tax Rates

The corporate tax rate for incorporated businesses in 2017 is 24% (set to be lowered to 23% in 2018). Permanent establishments are also subject to the regular corporate tax rate.

Capital gains and losses arising from real estate transactions located in Israel (including real estate associations) are taxed in accordance with the Land Taxation Law 5723-1963, at the applicable corporate tax rate.

Transparent entities, such as business partnerships, are generally not subject to Israeli taxation at the level of the partnership, but rather are taxed based on the pro rata rights of the partners to the partnership. Thus, individuals may be taxed up to a tax rate of 50% and companies in accordance with the corporate tax rate.

## 2. Key Features of the Tax Regime

### 2.1 Calculation of Taxable Profits

Israeli companies' income is taxed on a worldwide basis, while foreign companies are only subject to Israeli tax with respect to their Israel-sourced income.

The company's net income, calculated by Israeli accounting principles and reconciled with the provisions of the Israel Tax Ordinance (ITO) and regulations, determines the tax base for corporate tax purposes. In general, the accrual method of accounting is used by Israeli companies to report their income for accounting and tax purposes.

Tax and accounting rules differ in several areas, including accounting income derived from grouping rules that is eliminated for tax purposes; depreciation and amortisation rates; and specific categories of expenses that may not be fully deductible, such as overseas travel expenses, vehicle expenses and similar expenses determined by relevant regulations.

### 2.2 Special Incentives for Technology Investments

In order to encourage start-up investments, Israeli tax law allows the deduction of up to ILS5 million invested in the shares of a company, immediately, or over a three-year period, by an individual or a partnership, provided that certain conditions are met. This law is applicable until the end of 2019.

### 2.3 Other Special Incentives

Corporations deemed as "preferred enterprises" are entitled to a reduced corporate tax rate with regard to "preferred income" generated by the preferred enterprise within Israel. Depending upon their locations, the tax rates for preferred enterprises are 7.5% or 16% beginning in 2017 (depending on the region of the investment). Dividends distributed from certain preferred income, in accordance with the Law of Encouragement of Capital Investments, are subject to 20% tax.

More significant corporate tax reductions apply to large manufacturing companies, as profits of such companies are subject to 5% or 8% corporate tax.

In addition, "technology enterprises" that meet certain conditions are entitled to preferable corporate tax rates on their preferred income, ranging from 6% to 12%. Subject to meeting certain conditions, dividend distributions to foreign residents are subject to a 4% tax rate.

Assets and buildings used to produce certain preferred income are entitled to accelerated depreciation. During the first five years of operation, the company may depreciate its assets at 200% of the regular rate of depreciation with regard to equipment and 400% of the regular rate for buildings, with an annual ceiling of 20% of the value of the buildings.

Large manufacturing companies may also be eligible for grants of up to 20%, if certain conditions are met.

### 2.4 Basic Rules on Loss Relief

Losses incurred from a business or trade may be used to offset any other income or gain recognised by the company in the same tax year. Capital losses may only be offset against capital gains. Specific limitations apply to foreign source losses. Net operating losses of a company may be carried forward indefinitely, although they may not be carried back.

Carried forward loss generally survives ownership change, although Israeli courts have ruled that when the transaction was carried out for the sole purpose of utilising the carried forward loss, the loss will not be recognised against the income of the company following the acquisition. This was based on the anti-avoidance provision of Section 86 of the Ordinance, elaborated upon below.

### 2.5 Limits on Deduction of Interest

Generally, sums paid on interest or linkage differentials are deductible, provided that the capital was used for the production of the income. In certain cases, such as the receipt of income with special tax rates, or tax exempt status, the expenses used to obtain such income must be deducted, either proportionately or according to other methods, against the preferred income. Thus, in certain circumstances, holding companies may be required to deduct interest payments against exempted or special-rate income and therefore do not fully benefit from this deduction.

### 2.6 Basic Rules on Consolidated Tax Grouping

In general, Israeli law does not allow for consolidated tax grouping. However, Israeli-resident "industrial" companies (a company that receives 90% or more of its revenues from an industrial entity involved in manufacturing activity) or a holding company of industrial companies may consolidate tax returns and file a single consolidated tax return in respect of itself and its subsidiaries, who are also industrial companies, subject to the fact that the industrial companies included in the consolidated group are all part of a single manufacturing process or assembly line. In the event that an industrial holding company has subsidiaries engaged in different assembly lines, it may consolidate its return only with regard to the company, or companies with a single assembly line, in which it has the largest capital investment.

### 2.7 Capital Gains Taxation

Local corporations are subject to capital gains tax, according to the corporate tax rate (24% in 2017, set to be 23% in 2018) upon the sale of shares in other corporations. However, in the event that the corporation whose shares were sold is a non-publicly traded corporation, or is a public corporation if the selling corporation is a substantive shareholder (holds at least 10% of the means of control of the company), and has accumulated profits available for distribution then the portion of the selling company's gain attributed to the years prior to 2006 is subject to 10% tax, while the gain attributed to 2006 onwards is tax exempt.

Foreign corporations are generally exempt from capital gains tax upon sale of shares in Israel. See below for elaboration.

### 2.8 Other Taxes on Transactions

Incorporated businesses are subject to regular capital gains tax upon taxable transactions. In certain transactions, value added tax may be imposed, as detailed below. In addition, there is no stamp tax in Israel and transfer tax only applies upon certain transactions that involve purchase of land.

### 2.9 Other Notable Taxes

Israel has a value added tax (VAT) charged on transactions in Israel and on the importation of goods into Israel, the standard rate of which is currently 17% (as from 1 October 2015). A transaction that is a sale of goods is deemed to take place in Israel if, in the case of a tangible asset, it was delivered in Israel or exported and if, in the case of an intangible asset, the seller is an Israeli resident. Certain transactions are subject to a zero rate tax (mainly exports of goods and services) or exempt (such as certain financial services and specific real estate transactions). Financial institutions are subject to a profit tax and a tax on paid salaries (salary tax), both at a 17% rate, subject to certain adjustments. Businesses are entitled to recover input VAT costs in connection with goods or services used by them to create their taxable (including a zero rate) supply.

Israel imposes customs duties on certain imported goods and sales tax on certain imported and domestic goods. Israel also imposes several duties, such as trade levies and dumping levies, in accordance with the Trade Levy Law.

## 3. Division of Tax Base Between Corporations and Non-Corporate Business

### 3.1 Closely Held Local Businesses

It is difficult to ascertain how most closely held businesses operate in practice. However, in the event that they do incorporate, the responses laid out below will apply.

### 3.2 Corporate Rates and Individual Rates

The Israeli corporate tax regime is based on two-tier taxation: (i) tax at the company level — the corporate tax rate in 2017 is 24% (expected to be 23% in 2018) and (ii) tax at the shareholder level, upon dividend distribution — the dividend tax rate on shareholders who hold 10% or more of the company's means of control (substantive shareholders) is 30% (25% otherwise).

The highest applicable marginal tax rate on ordinary income is 47% (in 2017). Moreover, an additional 3% surtax will apply to any taxable income of an individual that is above ILS640,000.

Although dividend income is subject to a lower tax rate than ordinary income, along with the corporate tax rate, the total tax paid can be almost equal to the highest marginal tax rate applicable to ordinary income.

Nevertheless, recently enacted legislation subjects the income of closely held corporations, which stems from the personal exertion income of a substantive shareholder, to the marginal income tax rate, provided that several conditions are met. In addition, as elaborated upon below, in certain conditions a portion of the accumulated profits may be deemed as notionally distributed.

### 3.3 Accumulation Earnings for Investment Purposes

As mentioned above, subject to meeting certain conditions, closely held corporations are taxed on the income that stems from the personal exertion income of a substantive shareholder to marginal income tax rates.

In addition, in the event that a closely held corporation did not distribute a dividend with regard to at least 50% of its profit of a tax year, in the five years following the tax year, and its accumulated profits exceed ILS5 million, the distribution of such a dividend will not damage or negatively impact the company and the lack of distribution is a means of tax avoidance, the ITA may deem that up to 50% of such income was distributed as a dividend (subtracting actual dividends paid), provided that the accumulated profits of the company do not fall below ILS3 million.

### 3.4 Sales of Shares in Closely Held Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend and to a 30% rate if they are substantive shareholders (ie, hold 10% or more of the corporation's means of control). An additional 3% surtax applies on the income portion exceeding ILS640,000. In addition, pursuant to a temporary order, applicable until 30 September 2017, dividends on profits that arose until the end of 2016 that are distributed to substantive shareholders are subject to a fixed 25% tax rate (and the aforementioned surtax will not apply), subject to meeting certain additional conditions.

### 3.5 Sales of Shares in Publicly Traded Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend and to a 30% rate if they are substantive shareholders (ie, hold 10% or more of the corporation's means of control). An additional 3% surtax applies on the income portion exceeding ISL640,000. In addition, pursuant to a temporary order, applicable until 30 September 2017, dividends on profits that arose until the end of 2016 that are distributed to substantive shareholders are subject to a fixed 25% tax rate (and the aforementioned surtax will not apply), subject to meeting certain additional conditions.

## 4. Key Features of Taxation of Inbound Investments

### 4.1 Withholding Taxes

In the absence of an applicable income tax treaty, the following particular withholding taxes apply to foreign residents.

In general, payments made to foreign individuals are subject to 25% withholding tax and foreign corporations are subject to withholding tax pursuant to the corporate tax rate (24% in 2017).

Interest and royalties paid to non-resident corporations are generally subject to withholding tax at the corporate tax rate level (24% in 2017) and up to 50% in the event of a payment to a person who holds 10% or more of the company's stock.

Certain interest payments to non-resident investors are generally exempt from withholding tax, such as: (i) interest on certain traded government bonds, (ii) interest paid by an Israeli resident on a loan from a foreign resident and (iii) interest on deposits by a foreign resident, provided that the foreign resident does not conduct business or a profession in Israel.

Dividends distributed to non-substantive shareholders (who hold less than 10% of the means of control of the company) are subject to 25% withholding tax, while dividends to substantive shareholders are subject to 30% tax. However, if the Israel-resident company distributing the dividend is a publicly traded company, whose shares are held by a registration company, then 25% withholding tax will also apply to substantive shareholders. As noted, in the case of a dividend distribution by a preferred enterprise, a reduced rate of withholding tax of 20% applies; and in the case of a dividend distributed by a technology enterprise, a reduced rate of withholding tax of 4% may apply under certain circumstances.

### 4.2 Primary Tax Treaty Countries

As of 2017, there are over 50 double tax treaties to which Israel is a party that are in force in Israel. Israel generally follows the Organisation for Economic Co-operation and Development (OECD) model with the exception of a number of treaties (with the United Kingdom, Norway and Sweden) that were signed in the 1960s and the 1970s, before the OECD model was widely accepted. Israel signed the Multilateral Instrument in June 2017.

### 4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

An ITA circular describes the phenomenon of "Treaty Shopping" and lists several methods with which this issue may be confronted, such as:

- examining the residency of the entity, based on the rules determined in the relevant treaty;
- limitation of benefits provisions that allow the contracting states unilaterally or jointly to revoke or disallow benefits, in cases that the entity attempts to achieve tax benefits in an unworthy way, or if the activity is deemed to be abuse of the treaty;
- beneficial owner provisions, which determine that only the ultimate beneficiary may be the recipient of treaty benefits;
- interpretation of the treaty based on the Vienna Convention, which calls, inter alia, for treaties to be interpreted in good faith; and
- use of domestic anti-avoidance legislation, such as Section 86 of the ITO.

### 4.4 Transfer Pricing Issues
Foreign corporations that carry out activity in Israel must operate in accordance with accepted transfer pricing standards.

In an international transaction, in which there are special relationships between the parties as a result of which less profit was derived than if the price or conditions were between unrelated parties, the transaction must be reported according to the market conditions and it will be taxed accordingly.

Regulations published in 2006 specify certain methods to determine fair market value. The preferred method is to compare the price of the transaction with the price of a similar international transaction between unrelated parties. If this method cannot be implemented then the taxpayer must use one of the methods stipulated in the regulations. If neither of the methods indicated in the regulations can be used, the taxpayer is permitted to use any other suitable method of comparison.

The foreign-owned local affiliate is not specifically required to prepare an annual transfer pricing study; however, the tax-assessing officer has the authority to demand a transfer pricing study within a 60-day period. Moreover, the taxpayer is obligated to describe the terms of any international transaction with a party with whom it has a special relationship in its annual tax return.

### 4.5 Related Party Limited Risks Distribution Arrangements
This is an issue that the ITA has been examining. Recently many audits have been carried out by the ITA with respect to limited risk distribution arrangements.

### 4.6 Variation from OECD Standards
In general, Israel's local transfer pricing rules follow the relevant OECD standards.

## 5. Key Features of Taxation of Non-local Corporations

### 5.1 Taxation of Non-Local Corporation Versus Local Subsidiaries
A branch of a non-Israeli entity is taxed in Israel on the profits the branch derives from its Israeli activities, while a local subsidiary is generally taxed on its worldwide income. The corporate income tax rate in Israel is 24% (in 2017) and thus, the taxable profits of the branch allocable to Israel are subject to such tax.

Generally, there is no branch profit tax in Israel and profits may be distributed by the branch to the overseas headquarters without an additional layer of tax.

In the case of dividends paid by an Israeli subsidiary to overseas shareholders, the withholding tax rate is generally 30%, or if the Israeli subsidiary is listed on the Israeli Stock Exchange (TASE), the withholding tax rate is 25%. Such rates may be reduced under an applicable double tax treaty. The withholding rate in the case of a subsidiary can be alleviated if the profits are distributed only when the subsidiary is liquidated. In such a case, the capital gain that was derived from the liquidation as well as the distribution of the profits will be tax exempt in Israel. On the other hand, the sale of a branch by a non-local corporation is subject to capital gains tax in Israel.

### 5.2 Capital Gains of Non-Residents
Capital gains of non-residents on the sale of stock in corporations traded on the TASE are generally tax exempt, provided that the capital gain does not stem from a permanent establishment in Israel, from investments in certain real estate funds or from the sale of certain short-term bonds or loans.

With regard to capital gains of non-residents on the sale of stock in non-traded corporations, the gains are tax exempt, provided that they did not arise from a permanent establishment in Israel, that the stock was not purchased from a relative or is restricted due to a merger and that the principal value of the stock does not derive from real property, any asset attached to real property, or the right to benefit from real property situated in Israel, in any form or manner, or rights to use natural resources. It should be noted that a foreign resident who acquired the shares of an Israeli company after 1 January 2009 will often be exempt from tax in Israel on the sale of the shares.

The exemption on capital gains on the sale of stock of non-traded corporations also applies upon the sale of the shares of a non-local holding company that owns the stock of a local corporation, either directly or indirectly.

Certain treaties provide partial or full relief with respect to corporate tax on non-residents, subject to certain conditions.

### 5.3 Change of Control Provisions
In general, pursuant to the provisions of the ITO, a foreign resident company is exempt from tax on a capital gain generated from the sale of securities of an Israeli resident company or the sale of a right in a foreign resident company, the main assets of which are rights, either directly or indirectly, in assets located in Israel (subject to certain additional conditions).

As mentioned above, the tax exemption generally applies if the acquisition was made by a foreign resident after 1 January 2009, as opposed to an acquisition made before 1 January 2009, which is generally subject to capital gains tax in Israel.

### 5.4 Determining the Income of Foreign-owned Local Affiliates

The taxable profits of a local branch of a foreign company are generally calculated by reference to the income and deductions attributable to the branch under the assumption it operates as an independent business unit and in accordance with transfer pricing rules. The income tax regulations stipulate that if the transaction cannot be compared to a similar transaction, the value of the transaction should be determined based on the profit rate of the transaction, compared to similar international transactions, or carry out a profit split based on the contributions and risks of each party to the transaction. If none of the abovementioned methods is applicable then the most appropriate method must be applied on a case-by-case basis.

The ITO, however, does not include specific rules regarding the taxation of a branch or the allocation of income and expenses to a branch in Israel.

### 5.5 Deductions for Payments by Local Affiliates

There is no specific standard applied. The deduction must be carried out in accordance with the fair market value of such services.

### 5.6 Contraints on Related Party Borrowing

Israel does not impose thin capitalisation rules and therefore it is theoretically possible to finance a company with 100% debt. However, such a debt arrangement is subject to transfer pricing rules and must bear interest in accordance with market interest rate.

In addition, it is possible to provide an interest-free capital note, provided that the recipient of the loan is controlled by the provider of the loan, the loan is not linked to any index and does not carry interest or yield, the loan must not be repaid prior to a five-year period and its repayment must be subordinate to all other obligations of the company.

## 6. Key Features of Taxation of Foreign Income of Local Corporations

### 6.1 Foreign Income of Local Corporations

The foreign income of local corporations is subject to corporate tax, as in general, local corporations are taxed on their Israel-sourced and foreign-sourced income at the corporate tax rate (24% in 2017), as opposed to foreign companies, which are only subject to Israeli tax with respect to their Israel-sourced income.

### 6.2 Non-Deductible Local Expenses

Foreign income, as mentioned above, is subject to regular taxation, at the corporate tax rate.

### 6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are subject to regular corporate tax (24% in 2017). However, tax credit is available in such cases.

The Israeli local corporation may claim as credit foreign taxes paid with respect to the distribution pursuant to one of the following methods: (i) direct credit, where the Israeli company may claim credits with respect to foreign withholding tax paid on the dividend distribution, in which case, the dividend distribution will be subject to a 24% rate in Israel (in 2017); and (ii) indirect credit, where the Israeli company may claim credits with respect to its allocable share of the foreign taxes paid by the distributing company on its foreign source income and the foreign withholding tax paid on the dividend distribution, in which case, the dividend distribution will be subject to the regular corporate tax rate in Israel (which is also 24% in 2017).

### 6.4 Use of Tangibles

In general, in order for non-local subsidiaries to use intangibles developed by local corporations, the intangibles must be sold to the foreign corporation, or, alternatively, the local corporation may sign a licensing or royalties agreement with the non-local subsidiary, according to which they may use the intangibles in return for proper consideration. All the above is subject to compliance with transfer pricing rules.

### 6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

Non-local subsidiaries may be subject to controlled foreign corporation (CFC) rules, provided that they meet several conditions.

A controlling shareholder of the CFC is an Israeli resident (individual or corporation) that owns 10% interest or more in the CFC. The controlling shareholder's proportionate amount of the CFC's passive income is deemed as a dividend distribution to the controlling shareholder.

A CFC is a foreign company that is a foreign resident, not listed on an exchange, and if it is listed, less than 30% of the interests of the company have been offered to the public, not including shares held by controlling shareholders. In addition, most of the company's income must stem from passive sources and such passive income is subject to a 15% or less tax rate in the foreign jurisdiction. Moreover, the foreign company must be controlled by Israeli residents (ie, Israeli residents hold over 50% of the interests in the foreign company, or over 40% of the interests in the foreign company and together with the holdings of related parties, hold over 50%, or if an Israeli resident has veto power over major company decisions).

On the other hand, non-local branches of local corporations are deemed to be Israeli tax residents and are therefore subject to corporate tax on their worldwide income, whether from Israel or abroad. However, tax credit may be available in such cases.

### 6.6 Rules Related to the Substances of Non-Local Affiliates
As mentioned above, a company is deemed to be a resident of Israel if it was incorporated in Israel, or if it is managed and controlled in Israel, if it was incorporated abroad. Non-local subsidiaries of Israel resident companies are subject to a management and control test, according to which, a company is managed and controlled in the place where the business strategy of the company is determined, ie, where the principal substantive business decisions of the company are made. The location of the board of directors meetings is important, although not determinative, especially in a case where the board authorises a different organ of the company to manage the company. Israeli case law determined that a foreign company was managed and controlled from Israel when the managers of the foreign company were not substantially involved in the foreign company's business management and merely acted as an artificial platform for conducting the business of the Israeli company.

### 6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates
Local corporations are taxed on gain on the sale of shares in non-local affiliates according to the regular corporate tax rate (24% in 2017).

**Herzog Fox & Neeman**
Asia House, 4 Weizmann St.
Tel Aviv 6423904
Israel

Tel: +972 3 692 2020
Fax: +972 3 692 6464
Email: hfn@hfn.co.il
Web: www.hfn.co.il

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LAW OFFICE

## 7. Anti-Avoidance

### 7.1 Overarching Anti-Avoidance Provisions
The ITO includes a general anti-avoidance provision, Section 86, according to which, a tax-assessing officer may ignore transactions that are deemed to be artificial or fictitious, or if one of the main motives of such a transaction is tax avoidance. In addition, the "substance over form" doctrine constitutes a generally accepted principle of local case law.

## 8. Other

### 8.1 Regular Routine Audit Cycle
Generally, tax audits are carried out randomly and not all taxpayers and tax returns are examined.

In addition, within four years, and in certain circumstances five years, from the year in which a tax return was filed, the assessing officer may audit a company's tax return. The assessment of the officer may be appealed to another officer within the same local office. The decision of the second officer is subject to appeal to the district court. The decision of the district court may be appealed to the Supreme Court.