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Corporate Tax

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Herzog Fox & Neeman

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ISRAEL

LAW AND PRACTICE:

Contributed by Herzog Fox & Neeman

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

Herzog Fox & Neeman has the largest and most broadly experienced tax department of any law firm in Israel, comprising 15 partners and 25 associates, of whom several are also Certified Public Accountants and nine of whom studied in leading universities outside Israel. A number of its tax lawyers are also licensed to practise abroad and have worked in leading law firms in the USA. HFN has developed a thriving practice through its international tax department in the project management of outbound international tax planning and the design and management of multinational structures for global businesses. Members of the department, with years of experience at the forefront of public discussions on major domestic and international tax issues, advise the Finance Ministry and various tax authorities on proposed legislation and tax policy issues, and frequently play a role in the preparation and review of proposed changes to Israeli tax law and practice.

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic 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 such a partnership are subject to tax with respect to 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 is attributed to the representative and will not be subject to two-tier taxation.

1.3 Determining Residence

A company is considered resident in 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, though not determinative factor, especially where the board authorises 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 residents of Israel for treaty purposes and are usually eligible for treaty benefits based on the residency of the interest-holder.

1.4 Tax Rates

The corporate tax rate for incorporated businesses in 2018 is 23%. Permanent establishments of corporations 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 50%, and companies in accordance with the corporate tax rate.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for 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 certain conditions are met. This law is applicable until the end of 2019.

2.3 Other Special Incentives

Corporations deemed "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% as of 2017 (depending on the region of the investment). Dividends distributed from certain preferred income are subject to 20% tax, in accordance with the Law of Encouragement of Capital Investments.

More significant corporate tax reductions apply to large manufacturing companies, as profits of such companies are subject to 5% or 8% corporate tax (depending upon their locations).

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 resident companies 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 upper limit 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.

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

2.5 Imposed 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 industrial companies included in the consolidated group being 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 (23% as of 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, 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 **2.8 Other Taxes Payable by an Incorporated Business** for elaboration.

2.8 Other Taxes Payable by an Incorporated Business

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

2.9 Incorporated Businesses and Notable Taxes

Israel charges VAT on transactions in Israel and on the importation of goods into Israel, the standard rate of which is currently 17% (as of 1 October 2015). A transaction that is a sale of goods is deemed to have taken 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 profit tax and a tax on paid salaries (salary tax), both at a rate of 17%, 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 Businesses

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 Individual Rates and Corporate Rates

The Israeli corporate tax regime is based on two-tier taxation:

(i) tax at the company level - the corporate tax rate in 2018 is 23%, 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 2018). Moreover, an additional 3% surtax will apply to any taxable income of an individual that is above ILS641,880.

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 circumstances, a portion of the accumulated profits may be deemed notionally distributed.

3.3 Accumulating 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 has not distributed a dividend with respect to at least 50% of its profits in a tax year in the five years following the tax year, and its accumulated profits exceed ILS5 million, the distribution of the dividend does 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 by Individuals in Closely Held Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend and 30% 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 ILS641,880.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend and 30% 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 ILS641,880.

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 (23% in 2018).

Interest and royalties paid to non-resident corporations are generally subject to withholding tax at the corporate tax rate level (23% in 2018) 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 the foreign resident does not conduct business, or practice 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. 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 2018, 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) 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 whereby the entity attempts to secure tax benefits unlawfully, 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 had been between unrelated parties, the transaction must be reported according to the market conditions and 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, 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 obliged 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. Many audits have been carried out recently by the ITA with respect to limited-risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and 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 Compensating Adjustments When Transfer Pricing Claims are Settled

When a transfer pricing claim is settled, the ITA usually claim for a compensating adjustment. This adjustment may be in the form of a deemed dividend or interest on a loan. The Court in Israel has approved this position in its court decisions.

In a 2018 Supreme Court case, an Israeli company provided R&D services to its parent company in the form of a cost-plus arrangement. The Court ruled that as the price of the services the company provided to its parent company was higher than the amount reported to the ITA, the parent company had a debt for the extra amount that should have been paid. Due to this debt, the parent company should be charged with interest and therefore the Israeli company gained deemed interest income, which is subject to tax in Israel.

5.2 Taxing Differences

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 23% (in 2018) 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 this case, the capital gains 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.

5.3 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 gains do 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 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 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.

5.4 Change of Control Provisions

In general, pursuant to the provisions of the ITO, a foreign-resident company is exempt from tax on capital gains 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.

5.5 Formulas Used to Determine 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 that 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 a profit split should be carried out based on the contributions and risks of each party to the transaction. If none of the above-mentioned 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.

5.6 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.

5.7 Constraints 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, this type of debt arrangement is subject to transfer pricing rules and must bear interest in accordance with the market interest rate.

In addition, it is possible to provide an interest-free capital note, provided 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 (23% in 2018), 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 (23% in 2018). However, tax credit is available in such cases.

The Israeli local corporation may claim foreign taxes paid with respect to the distribution as credit 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 23% rate in Israel (as at 2018); 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 (also 23% as at 2018).

6.4 Use of Intangibles

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 royalty 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 a dividend distribution to the controlling shareholder.

A CFC is a foreign company that is a foreign resident, not listed on an exchange, though if listed, less than 30% of the interests of the company should 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 Substance 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 was incorporated abroad and is managed and controlled in Israel. 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 determines a foreign company to be managed and controlled from Israel, whereby the managers of the foreign company are not substantially involved in the foreign company's business management and merely act 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 (23% in 2018).

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 end of the tax 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.

9. BEPS

9.1 Recommended Changes

Israel has already begun to implement certain BEPS recommendations and we expect this process to continue gradually. So far, implementation has mostly occurred through changes in the interpretation of existing law and tax treaties, rather than through changes in legislation.

In 2016, following BEPS Action 1, which focuses on the digital economy, the ITA published a guidance paper addressing the taxation of income applicable to non-Israeli internet companies selling goods or providing services to the Israeli market through the internet, as well as the VAT liability of internet services companies. The guidance paper extends to the VAT registration obligation of non-Israeli companies active in the Israeli market and, in addition, provides new, broader interpretations with regard to the definitions of a permanent establishment conducted through dependent agents and fixed places of business.

Following BEPS Action 5, which addresses harmful tax practices, and consistent with the OECD's so-called "nexus approach" relating to preferential tax regimes for intellectual property, the Israeli government recently enacted legislation granting preferential tax rates to technology and hi-tech companies with respect to income derived from intellectual property development activities carried out in Israel. The new legislation determines a new IP regime in Israel by granting preferential tax rates to technology and hi-tech companies developing their intellectual property in Israel. In order to be entitled to these preferential rates, the new legislation sets out certain complex conditions to ensure that the benefits are only provided when the IP is actually developed in Israel. These tax benefits are part of a significant reform under the Law for the Encouragement of Capital Investments, in light of the recommendations of the OECD BEPS Project.

Proposed legislation to implement the BEPS Action 13 recommendation regarding transfer pricing documentation (including a "Country by Country" report and master and local filings) has already been published. The proposed legislation enacts a new reporting regime for taxpayers of a multinational entity that has engaged in an international transaction. In this regard, the taxpayer may be required to provide the ITA with the complete documentation regarding the international transaction, including documents regarding the method used for the price calculation, as well as forms and information regarding the multinational enterprise itself.

9.2 Government Attitudes

The ITA has indicated that it intends to follow and implement the OECD's recommendations in the BEPS reports and, accordingly, we expect to see amendments to domestic legislation, the enactment of regulations and the publication of guidance papers by the ITA, which will indicate the ITA's position. In addition, discussions with Israel's treaty partners are anticipated, and the OECD's recommendations implemented. Israel is also a signatory to the Multilateral Instrument ("MLI").

9.3 Profile of International Tax

International tax has significant media exposure and hence a high public profile in Israel, especially with respect to the taxation of non-Israeli internet companies, which has given rise to public protest. The protesters claim that these non-Israeli internet companies, such as Google, do not pay sufficient tax on their activity in Israel. We expect that the media focus on this issue, together with the high public profile, will increase Israel's motivation to implement the BEPS recommendations.

9.4 Competitive Tax Policy Objective

Although the government is trying to encourage investment in the Israeli economy, we expect the competitive tax policy to be restricted as a result of the BEPS recommendations, which will surpass other considerations.

An example of this can be seen in the recently enacted Law for the Encouragement of Capital Investments, which provides for preferential tax rates to be granted to technology and hi-tech companies, but only with respect to income derived from intellectual property development in Israel. This law was revised in accordance with BEPS Action 5. In this regard, the Israeli regulations have adopted the principle proposed in the BEPS rules (the so-called "Nexus Approach") for calculating the qualifying income and the benefited capital gain, in order for it not to be considered a harmful tax regime.

9.5 Features of the Competitive Tax System

As part of the Law for the Encouragement of Capital Investments, Israel grants extensive tax benefits to Israeli manufacturers. In certain cases, this contradicts BEPS Action 5 and the Nexus Approach, which limits the ability to grant benefits where the IP has not been developed in Israel.

9.6 Proposals for Dealing with Hybrid Instruments

Israel has not yet implemented these changes and there is no draft legislation proposing implementation. However, as stated above, the Israeli government is committed to implementing the BEPS recommendations and, as such, we expect the legislation to be published in the near future.

9.7 Territorial Tax Regime

Israel has a territorial tax regime (combined with a personal tax regime). However, there are no interest-deductibility restrictions or thin-capitalisation rules. We are not aware of any intention on the part of the ITA to enact such rules.

9.8 CFC Proposals

Israel has a very sophisticated CFC regime, ratified almost 15 years ago. The main features of the Israeli regime are very similar to the BEPS recommendations regarding the CFC rule. Accordingly, we do not expect any significant change to the Israeli CFC regime as a result of the BEPS legislation.

9.9 Anti-Avoidance Rules

Israel maintains a conservative approach with respect to granting treaty benefits, and such benefits are granted subject to the existence of substance in the treaty country.

There is an LOB clause only in a minority of the Israel treaties (though it exists in the Israel-US treaty). However, there is a court ruling determining that Israel is entitled to implement anti-avoidance doctrines from its domestic legislation when interpreting tax treaty provisions. For example, the establishment of a foreign company in a treaty country may be considered an artificial transaction, where the purpose is to avoid the payment of tax.

It should be noted that, as stated above, Israel is also a signatory to the Multilateral Instrument ("MLI").

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Israel complies with, and encompasses most of, the BEPS proposals with respect to the DTC limitation. Accordingly, we do not expect significant impact on inbound and outbound investors.

9.10 Transfer Pricing Changes

In 2018, the ITA published two circulars concerning transfer pricing.

The first circular provides guidance, which is based on the OECD transfer pricing guidelines, for identifying and analysing intercompany activity and the TP method most appropriate for determining the activity's part in the entire group business activity. In accordance with the BEPs recommendation, the circular suggests that the analysis should first begin by reviewing the contractual arrangements, followed by examining the parties' conduct in order to ascertain if it is consistent with the contractual arrangements.

The second circular, also based on the OECD transfer pricing guidelines, presents the ITA's position with respect to a number of transactions, while reducing the burden of the documentation and reporting requirements, by way of the safe-harbour principle. The circular sets a safe harbour for the following transactions: (i) low-value-adding services, having an operating profitability of net cost plus margin of 5%; (ii) marketing services, having operating profitability of net cost plus margin between 10%-12%; (iii) low-risk distribution services, having an operating profitability of sales as turnover of between 3%-4%.

The circular mentions that the margins will be revised from time to time.

9.11 Transparency and Country-by-Country Reporting

We believe that the BEPS proposal for transparency and country-by-country reporting will improve enforcement and that, overall, the proposal is proportionate, as it only applies to large entities and will not impose unreasonable compliance costs on small entities.

As previously mentioned, there is proposed legislation in Israel to implement this recommendation.

9.12 Taxation of Digital Economy Businesses

The ITA has published a guidance paper, which is focused on the taxation of income by non-Israeli internet companies selling goods or providing services to the Israeli market through the internet, as well as the VAT liability of internet services companies. The guidance paper generally provides new, broader interpretations to the definitions of a permanent establishment conducted through dependent agents and fixed places of business, and expands the VAT registration obligation of non-Israeli companies active in the Israeli market.