1. Israeli Tax Treaties – General Overview

This year marks Israel's 60th anniversary. The country is known for having a relatively high volume of international economic activity, both incoming and outgoing (its population currently standing at a mere 7.2 million). Despite its young age, the state of Israel is already a party to 47 bilateral treaties for the avoidance of double taxation[1] (hereinafter, "treaty" or "treaties"); several others are under negotiations or pending validation.
The vast majority of Israel's treaties are based on the Model Tax Convention of the Organization for Economic Cooperation and Development (OECD) (hereinafter, "Model Convention"). While not bound by OECD commentaries, or by reports published by the Organization on issues of international taxation, the Israeli tax authorities in practice nonetheless tend to interpret Israel's treaties in accordance with these.
Once a treaty is made part of Israeli law, its provisions take precedence over domestic law.

2. The Role of Tax Treaties

Tax treaties set rules for allocating taxation rights among the contracting states. The right of a contracting state to tax a particular item of income may be primary, residual or exclusive. In case a state is granted a primary right of taxation, also referred to as "the right of first bite" (usually it will be the "state of source"), the other contracting state (usually "the state of residence") may also tax the income, subject to the obligation to avoid double taxation of the same income.

A central pillar of any tax treaty is the term "residence". The treaty applies to residents of either contracting state. In most cases, the state of residence possesses the right to tax income of its residents, while that of the state of source is often limited, made subordinate to the latter or rendered non-existent. Hence, the ability to determine the fiscal residence of a person (an individual or a legal person) is of crucial importance. The treaty itself establishes "tie-breaking rules" for resolving situations of dual residence (i.e. each of the two states regards a person as resident therein, under its own respective law), thus establishing a single residence for treaty purposes.

Needless to say that tax treaties serve as an instrument for exchanging fiscal information between the contracting states. However, it is only

[1] Israel has concluded treaties with most of OECD countries and with most of EU countries.

information necessary in order to execute the treaty's provisions or the domestic law of either state which may be obtained this way.

3. Basic principles in Israeli Tax treaties

Prevention of Double Taxation

Israel employs the "credit method" in its double taxation treaties. Some treaties provide for an "underlying credit" as well, in which case any tax paid to a foreign state by a foreign company in relation to its profits, may be credited against Israeli tax levied on dividends distributed from those profits[2].

Some treaties include a "tax sparing" mechanism, designed to secure income tax benefits offered by one state in relation to income generated therein from designated activities. The other state is hence obliged to credit the tax that would have been payable in the state of source, but for a specific tax exemption or reduction.

Taxation of Business Profits

As a rule, business profits of a resident of either contracting state may only be taxed by the state of residence; nevertheless, where the resident has a permanent establishment (hereinafter – "PE") in the other state, through which he conducts his activity, that other state may tax that part of the profits which is attributable to the PE.

Taxation of Dividends

Israel retains the right to tax dividends distributed by resident companies. If those are distributed to a company of the other state that has substantial participation in the paying company's capital (or voting power), the rate is usually low (5% in most recent treaties). In other cases, the rate is usually higher (15% - in most recent treaties). However – as expressed in the "Non-Member Countries' Positions on the Model Tax Convention"[3] - Israel reserves the right to impose a higher rate of tax withholding (usually 10%) on dividends paid out of profits that were themselves taxed at a rate lower than the normal corporate tax rate in Israel[4].

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2 In most cases the credit method will be reciprocal, but the contracting states are free to choose otherwise. In Israel, the underlying credit is add to allowing credit for the tax withheld at source upon distribution of the dividends.

3 Included at the end of OECD's publication, Model Tax Convention, July 2005.

4 **Israeli Law for Encouragement of Capital Investments**, 1959 offers significant tax benefits, as well as tax exemption, for specific activities in preferred regions. Corporate rate may range between 0% and 25%, for specific periods of time.

Taxation of Income and Capital Gains on Real Property

Income and capital gains deriving from real property (referred to as "immovable property" in the Model Convention) located in a contracting state may be taxed in that state. In most cases, the state of residence may also tax such profits and must avoid double taxation. The same rule usually applies to gains on the sale of shares in a company (or other entity) over 50 per cent of all whose assets comprise, directly or indirectly, immovable property situated within a contracting state.

Capital Gains

As for disposition of company shares (other than real estate entities) - about one half of Israeli tax treaties allow the state in which the relevant company is resident to tax gains on such a sale. This right is often conditional on the alienator's holding a certain minimum percentage of the company's share capital or voting power. In recent years, however, Israel no longer offers to introduce such a rule into its treaties. Thus, recent treaties usually follow article 13 of the Model Convention, which grants an exclusive taxing right to the alienator's state of residence.

Residents of states that have what may be termed "old-school" treaties with Israel may nevertheless be eligible for an exemption on such gains, under Israeli domestic law. Gains on shares listed on the Israeli Stock Exchange are tax-exempt[5]. As for capital gains in private companies, these may be tax-exempt under a provisional section in the Israeli ITO that was recently enacted[6].

Taxation of Interest and Royalty Payments

When it comes to interest and royalty payments, the vast majority of Israeli treaties allow the state of source a limited taxation right.
Often however, when the interest is paid to the government of the other state, to its central bank or to other institutions thereof, a lower rate (or zero-rate tax) is set.

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[5] Article 97(B2) of the Israeli Income Tax Ordinance 0f 1961 - ITO.
[6] Article 97(B3) of ITO. Currently, the exemption may be applied to investments made from July 2005 until the end of 2008.

4. Treaties with EUMAFINOR States

Currently, Israel is a party to tax treaties with Germany, Italy, France, the Netherlands, Belgium, South Africa, Switzerland and Luxembourg[7]. Being concluded at different periods in time, the treaties differ from one another, and reflect a divergence of tax rules and rates. Some of those treaties may offer foreign residents investing in Israel substantial benefits, and may prove to be advantageous for tax-efficient structures.

The Treaty between Israel and Germany

Having entered into effect in 1966, it is one of Israel's earliest treaties. The maximum permissible withholding rate from dividends is 25%, a rate which is higher than the applicable withholding rate under current German law[8], and may be higher than the currently applicable withholding rate under Israeli law[9]. The maximum withholding rate from interest is 15%, and 5% from royalty payments.

A German resident may be exempt from Israeli tax on gains arising on the sale of shares in a private company all of whose assets comprise Israeli real property (notwithstanding ancillary assets thereto). This benefit takes priority over domestic Israeli law, which allows the taxation of such gains. It may be noted that most of Israel's treaties allow Israel to tax capital gains on shares representing, economically, real property located in Israel.

This treaty also provides (reciprocally) a benefit for underlying tax which is favorable, compared to credit of this sort allowed to Israeli residents under Israeli law (an individual taxpayer may benefit as well).

The Treaty between Israel and France

A unique provision in this treaty states that income generated from real property located in either contracting state may only be taxed by that state. No doubt this provision, the likes of which is rare in other

[7] Israel has not concluded treaties with Cyprus, Malta and Mauritius, nor has any such treaty been negotiated yet.
8 Dividends distributed by a German company are subject to withholding tax (*Kapitalertragsteuer*) at a rate of 20% (Sec. 43a(1) No. 1 EStG), increased to 21.1% by the 5.5% solidarity surcharge – if the recipient is not a resident of an EU country.
[9] According to article 170 of the ITO and the appropriate regulations, the withholding rate from dividends paid to a non-resident, substantial shareholder is 25%; otherwise it is 20%.

treaties of Israel, may prove to be beneficial, given the reduction[10] or exemption from Israeli tax on rental income deriving from a residential apartment[11]. Thus, French residents may derive rental income from their apartments located in Israel completely tax–free (in both Israel and France).

However, this treaty provision only applies to income deriving from real property – not to capital gains deriving from the alienation of such property. The latter are subject to a separate rule: they may be taxed by the state in which the asset is located (state of source), *as well as* by the alienator's state of residence – subject of course to its providing a relief.

The Treaties between Israel and Switzerland and Luxembourg

These are amongst Israel's more recent treaties, and basically follow the Model Convention. Withholding rates are relatively low – 5% or 10% for interest, 5% for royalties. With regard to dividends, those distributed to a company holding a "substantial participation" in the company (10% and more) are subject to tax at a rate of 5%. Dividends distributed by an Israeli resident company, from profits which were themselves taxed at a rate lower than the normal rate of corporate tax [12], may be subject to withholding tax at a rate of 10%. In all other cases, maximum rate of withholding tax from dividends is 15%.

Under both treaties, capital gains on the alienation of assets not dealt with specifically under first paragraphs of article 13 may only be taxed by the alienator's state of residence, insofar as the alienator is the beneficial owner of that asset. This exclusion from taxation in the state of source was not made conditional on the gain being taxed by the state of residence.

It follows that a Swiss or Luxembourgian resident's capital gains arising from the alienation of shares in an Israeli resident company are not subject to Israeli tax. These may only be taxed under the law of the state of residence.

the reference to "beneficial ownership" is often found in articles 10, 11 and 12 of the Model Convention (respecting dividends, interest and royalties, respectively) but not in article 13 (dealing with capital gains). It appears from this divergence of article 13 in each of these treaties from its Model Convention counterpart, that the contracting

[10] 10% flat rate, provided the taxpayer does not claim any deductions.
11 Rent income deriving from a residential unit in Israel of up to 4,2000 NIS per month is tax-exempt.
[12] Under the Israeli Law for Encouragement of Capital Investments, 1959, remark no. 4.

states' intention was to confer treaty benefits on those who are economically entitled to the gains in question.

The Treaty between Israel and the Netherlands

This treaty, effective 1.4.1970, involves several important aspects. Article 15, dealing with capital gains, defines the term "immovable property". As far as real property entities are concerned, the definition in that treaty refers to rights (other than shares listed on a stock exchange) in "a real estate association as such association is defined in the Israeli Land Appreciation Tax Law". However, this type of association is not identical to the concept of a company (or other entity) over 50 per cent of all whose assets comprise, directly or indirectly, immovable property situated within a contracting state, referred to in the Model Convention. This distinction might have tax consequences. For example, a company that owns Israeli real property as inventory may not be regarded a real estate association under Israeli Law – even where most of its assets is land in Israel. In such a case, Israel is deprived of its right to tax gains on the company's shares. These would fall within "other assets" under article 15(4) of the treaty, and may only be taxed by the state of residence.

Article 15(5) preserves the right of a former (contracting) state of residence to tax the former resident's gains on shares in a company resident therein, although he is a resident of the other state at the time of sale. This right is conditional on several requirements. It should be noted in this regard that Israeli law includes what is known as "exit tax": change of residence is deemed a tax event. If tax is not however paid at that time, it must subsequently be paid upon actual disposition of the asset[13].

The Treaty between Israel and Belgium

Withholding tax rates set in this treaty are: 15% from dividends and interest payments, 10% from royalties.

Article 23 of the treaty sets rules for the avoidance of double taxation. Belgium applies the "exemption with progression" method[14] in relation to income derived by a Belgian resident,(other than type of income

[13] Section 100A of ITO.

[14] Article 23(b) of the treaty. This mechanism of exemption with progression can also be found in other Belgian treaties, and may prove to be advantageous for Belgian residents in structuring their foreign investments.

referred to in art. 23(a)), which may be taxed in Israel according to the treaty. Hence, income from real property located in Israel, being taxable in Israel under the treaty, should not be taxed in Belgium. It seems the reservation to that rule[15] should not affect the exemption in Belgium where such income was exempt by virtue of Israeli law.

5. <u>Israeli Tax Treaties – Some Practical Aspects</u>

- It is a common practice for the Israeli tax authorities to require those who claim a benefit under a tax treaty to present a certificate of residence from the competent authority in their state[16].
- Israeli authorities are considered cooperative and (in most cases) are willing to issue a certificate of residence for Israeli taxpayers operating abroad, and a certificate of tax paid in Israel by non-residents.
- Like in many other countries, the Israeli tax authorities seek to prevent the abuse of treaties. Israeli tax authority's position is that it is every bit as justified in refusing to recognize abusive use of tax treaties,, not only on the basis of tax treaty law but also based on domestic Israeli law , by ignoring shaam transactions and other acts designated only for the purpose of tax evasion.[17]

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The above article is also expected to appear in STEP's Avanti *magazine (forthcoming)*

[15] Article 23(1)(b)(iii)
[16] Form A114 – claim for reduced rate/exemption from withholding tax in Israel for non-residents.
[17] Income tax circular no. 3/2001 on the prevention of treaty-based tax planning, published May 2001.