2023 Year-end Circular

BDSK
Ben David Shalvi Kop

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Dear clients!

We are approaching the end of 2023. We have all been going through difficult days, while trying to manage a "war routine" as best we can. In light of the situation, the Tax Authority has published alleviating guidelines for businesses and representatives in addition to the various grants, which are reflected, among other things, by extending deadlines for submitting reports, freezing collection procedures and enforcement of overdue assessments, and more, in addition to the directive to reduce audits of taxpayers' files.

At the same time, in a retrospective review of the past year in terms of taxation, there are new topical guidelines and rulings that have been published, as well as committee decisions that could have a significant impact on various areas in the world of taxation.

In the circular below we will bring you tax updates on a variety of topics. It is important to note that some of the updates have not yet been approved in the Knesset plenum, but it is highly likely that they will be approved in the coming tax year and may substantially affect various tax issues. Among the updates, we have noted some topics that have not yet been approved.

We also plan to publish regular updates from time to time during the 2024 tax year, and a more comprehensive and broader review of several chapters of different tax issues that have become more relevant recently, and more closely enforced by the Tax Authority.

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In this circular, we will discuss the following topics:

- The interest rate
- Real estate
- The Arrangements Law
- The reform of international taxation
- The Law for Encouragement of Knowledge-Based Industry
- VAT issues regarding import of services and provision of service to foreign residents
- Profits suitable for distribution
- Change of purpose
- Ruling updates

The full circular is in Hebrew; below is a summary of the circular in English, and details of issues related to international taxation and VAT issues that are relevant to foreign residents.

It is important to emphasize that the information presented here is general, and is intended to direct your attention. Each specific case should be examined on its merits and an individual opinion and advice should be obtained accordingly.

The tax department at our office deals with a wide range of issues, and will be happy to provide you with consultation and support services in various fields, including: international taxation, taxation and reporting on trusts, accompanying transactions, writing professional opinions on diverse topics, tax benefits under the Capital Investment Promotion Law, specialization in the field of structural changes starting with the transition from a business to a company, through planning and changes in the structure of holdings, to the merger of companies, splits, and so forth, representation in discussions with the tax authorities, and more...

You are welcome to contact us with any professional questions or for transaction support, and we will be happy to be at your service!

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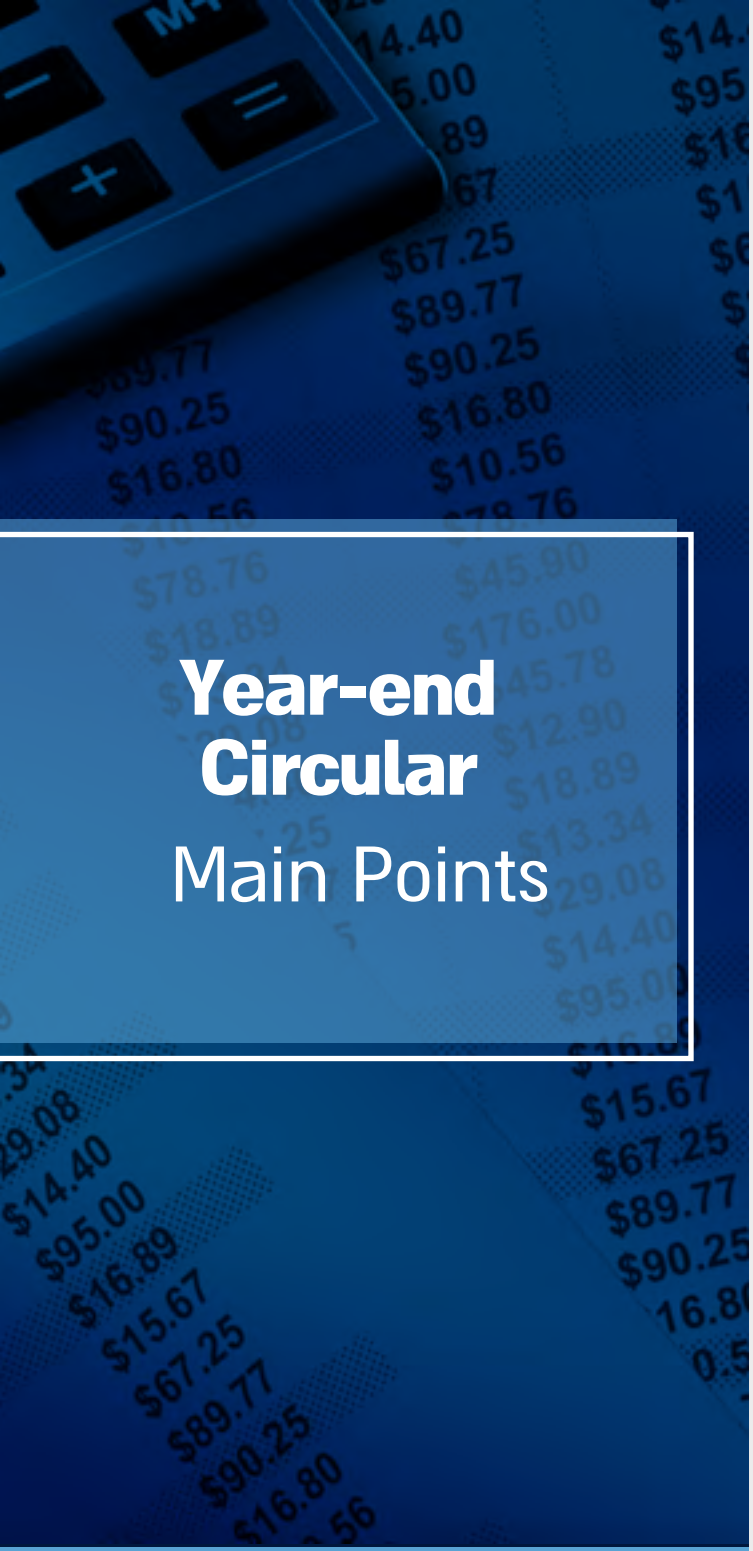
Sincerely,

BDSK Tax Department – Ben David Shalvi Kop & Co.

Certified Public Accountants



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Main Points

1 The interest rate

The price of money affects the economy and can be a factor that encourages or inhibits consumption, investment and the stability of the economy. Therefore, setting interest rates is a tool for managing the monetary policy of the economy. Until 2021, the global interest rate was very low, while the base interest rate in Europe was even negative for a certain period of time. However, the emergence from Covid changed the rules of the game.

2 Real estate

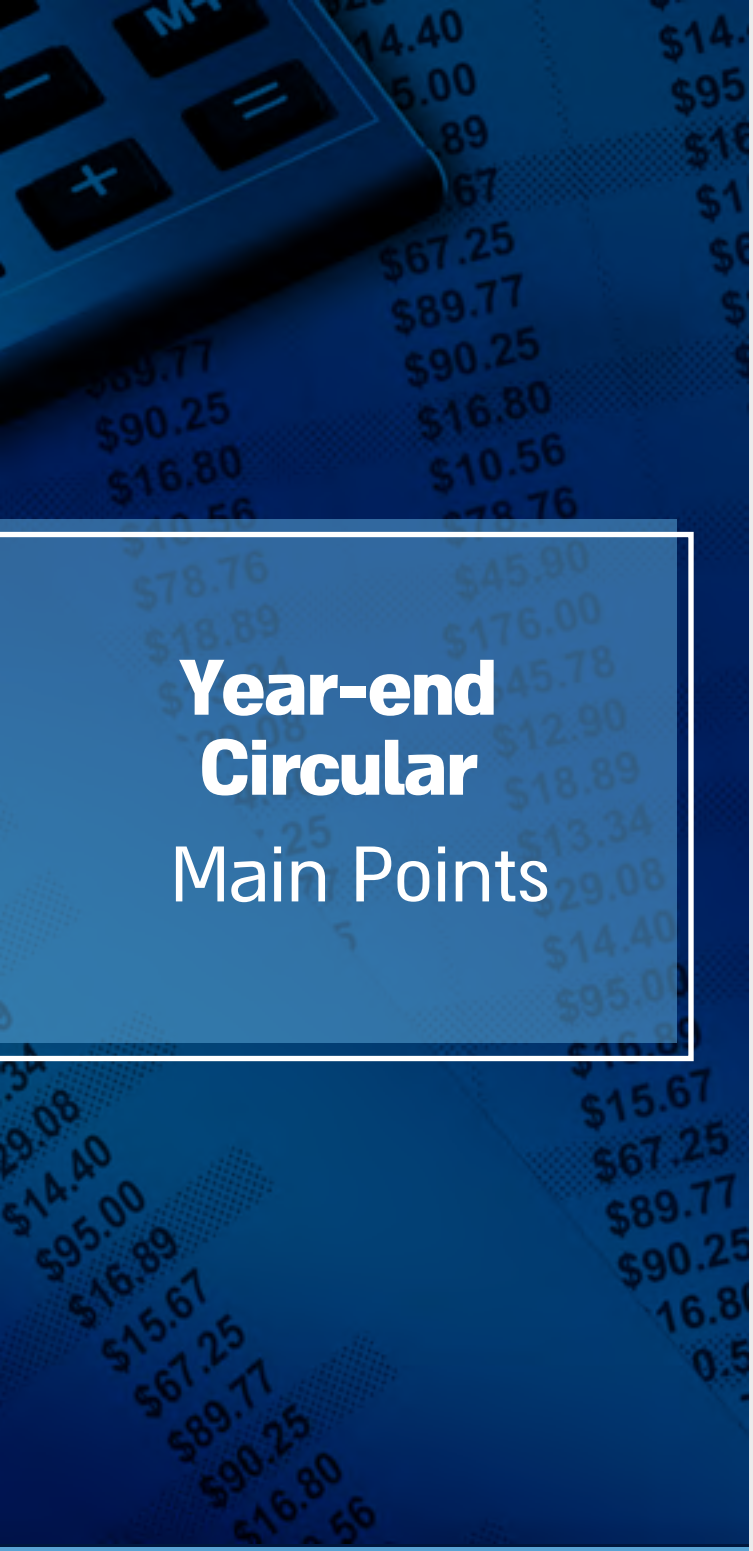
As the State of Israel develops, real estate comes to occupy more of the newspaper headlines and public discourse. In this section, we will analyze in general terms the characteristics of the real estate sector and the way in which the outbreak of the war may affect it.

3 The Arrangements Law / amendments to legislation in the field of taxes

The Arrangements Law for the years 2023-2024 presents a series of legislative amendments in the field of taxes – income tax, VAT and real estate taxation. This section includes a concise and focused review of these amendments.

4 The reform in international taxation

The Tax Authority convened a special committee whose purpose is to provide recommendations for legislative amendments in the fields of international taxation. In November 2021, the committee submitted a detailed report that includes its recommendations these amendments, and during 2023,



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three memoranda of law were submitted based on the committee's recommendations, dealing with changing the definition of Israeli resident, extensive amendments to the foreign tax credit mechanism, and special instructions regarding a controlled foreign company and a professional foreign company.

5 The Law for Encouragement of Knowledge-Based Industry (temporary order)

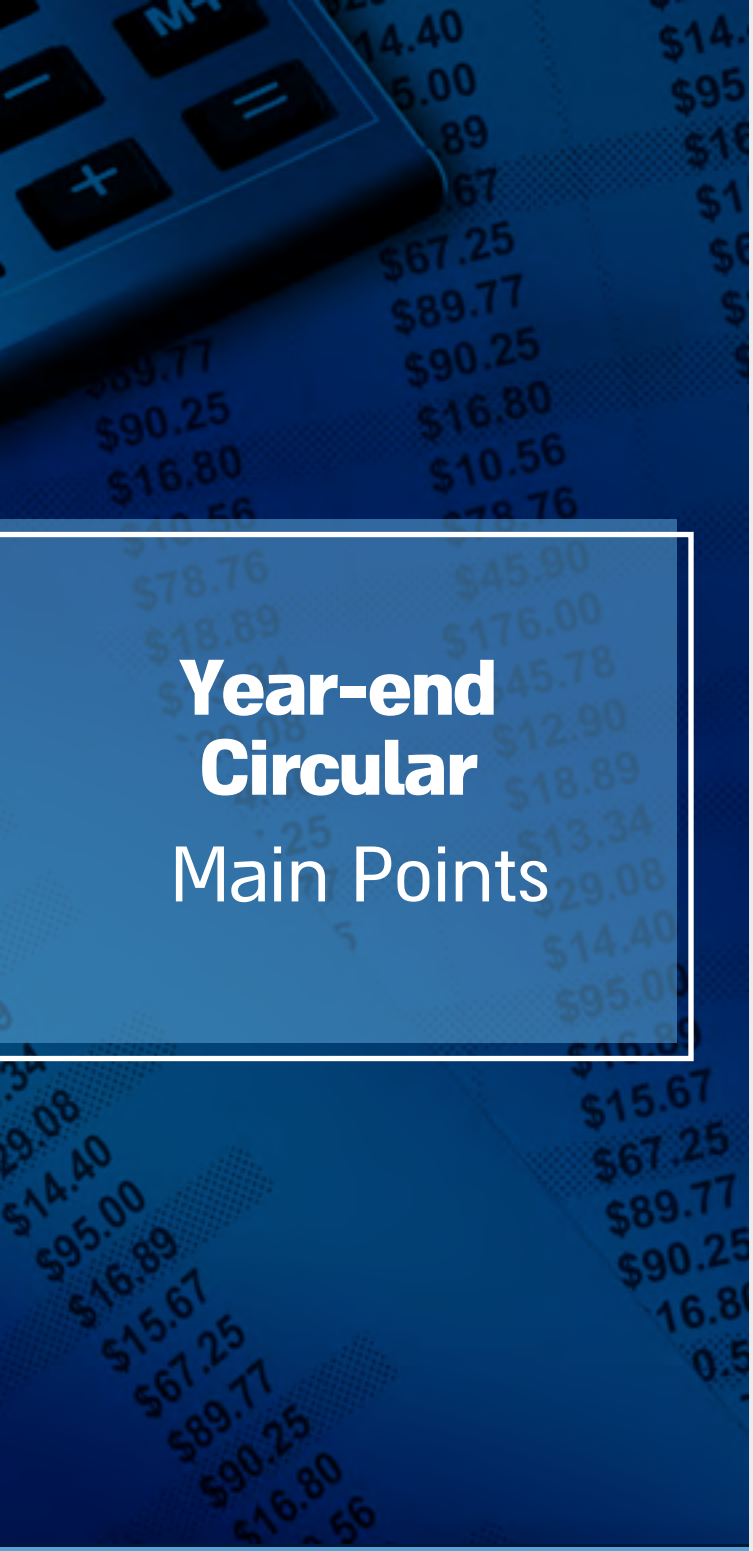
In order to preserve Israel as an attractive destination for investment in technology companies and to support development of this industry, with the emphasis on high-tech companies that are in the early stages of their activity, in July 2023 the Knesset approved the Law for Encouragement of Knowledge-Based Industry. The law grants tax benefits to investors in Israeli high-tech companies, as well as benefits to technology companies undergoing a process of merger or acquisition with other high-tech companies.

6 Value Added Tax on the import of services to Israel and the provision of services to foreign residents

Many of us import services from abroad, such as: consulting services, legal services, employment of subcontractors, brokerage, etc. The import of services into Israel may be subject to VAT (the law establishes the conditions and provisions applying to importing services to Israel).

7 Zero rate VAT on the provision of services to foreign residents

In order to encourage the export of services outside of Israel, Article 30(a)(5) of the Value Added Tax Law states that the provision of a service to a foreign resident in Israel will be subject to zero rate VAT. This article is a relief for businesses because charging zero VAT allows for the deduction of tax on the inputs used by the business.



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8 Profits suitable for distribution / a worthwhile tax benefit

When selling company shares, the selling shareholder has two alternatives: one – drawing a dividend equal to the seller's share of the remaining surplus accumulated in the company and then selling the shares, and the second - selling the shares without drawing dividends. In this alternative, the consideration for their sale expresses not only the intrinsic value of the share, but also profits accumulated in the company and not distributed up to the sale of the shares. Article 94b of the Ordinance applies a unique taxation mechanism whose main purpose is to compare the final tax to be paid in the two sales alternatives, which when used correctly and intelligently may provide a significant tax benefit.

9 Change of designation – a tax accident or an opportunity worth knowing?

At the basis of tax collection in Israel is the realization principle. That is, the tax charge will only be on income received, and not on theoretical income such as the increase in the value of an asset that has not yet been sold. There are a number of exceptions to this principle, and one of the most prominent of these is a change of designation = a change in the purpose for which the asset is held by the owner, without an actual change in the asset's ownership.

Change of designation may require the payment of tax by the seller, and in certain cases may even produce critical tax accidents. In other cases, the proper use of the relevant clauses may generate a significant tax advantage.

10 Ruling updates

Court rulings on various taxation issues are a useful tool for interpretation where the provisions of the law are not unambiguous, and in some cases are even binding thereafter.

Below are a number of important rulings published in the past year that may have an impact on similar tax issues.

The Reform in International Taxation

Since 2003, Israel has practiced the personal taxation system – a resident of Israel is liable for income tax both on income generated in Israel and on income generated outside of Israel. Over the years the need has arisen for a substantial legislative amendment due to changes that have occurred in international trade and economic patterns, the need for cooperation between countries in planning a tax collection system based on thwarting international tax planning that abuses the gaps in the taxation mechanisms applying in different countries, implementation difficulties and loopholes that have been discovered over the years in the existing law, and more.

In November 2021, the Committee for International Taxation Reform submitted a detailed report that includes its recommendations for legislative amendments in international taxation, and during 2023, three memoranda of law based on the committee's recommendations were submitted.

It should be emphasized that there has not yet been a change in the existing legal situation so long as the law has not passed the second and third readings, but there is a high probability of a legislative change on the subject in accordance with the proposed outline. Below is a concise overview of the proposed legislative amendments:

Amending the definition of a resident of Israel

The current situation:

The current definition of "resident of Israel" in the Ordinance is based on determining the center of the taxpayer's life ("center of life test"), taking into account all relevant aspects, for example: the place of the taxpayer's permanent home, the place where his economic / social / business interests are concentrated, etc. In addition, a rebuttable presumption was established based on the number of days of stay in Israel ("the days test"), which includes 2 alternatives:

1. A stay of 183 days or more in the tax year

2. A stay of 30 days or more in the tax year, and 425 days cumulatively in the tax year and in the 2 years preceding it

In accordance with extensive rulings on the subject, the decisive test is the center of life test.

"Foreign resident" is defined in the Ordinance as:

1. Anyone who is not a resident of Israel

2. An individual who meets 2 cumulative conditions:

2.1. In the tax year and the following tax year he spent fewer than 183 days in Israel

2.2. In the following 2 tax years, the center of his life was abroad

Proposed amendment:

Since the center of life test is individual and based

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to a large extent on the exercise of discretion and subjective aspects, and the days test includes rebuttable presumptions, there is a certain degree of uncertainty in determining the residency of individuals. In addition, frictions naturally arise between the taxpayers and the tax assessor, and aggressive positions are taken by taxpayers in order to enjoy tax benefits. Therefore, it is proposed to establish **conclusive presumptions** based on **the number of days the taxpayer stays in Israel and/or abroad** without taking into account the center of the taxpayer's life.

Proposed presumptions for determining residency in Israel:

- Stayed in Israel for 183 days or more in two consecutive tax years
- Stayed in Israel for 100 days in the tax year, and 450 days cumulatively in the tax year and in the two years preceding it (the presumption will not hold if the individual spent at least 183 days in each of the 3 tax years under consideration in a treaty country)
- An individual who stayed in Israel for 100 days in the tax year whose spouse is a resident of Israel

In order to determine that a taxpayer is a foreign resident, a number of alternatives are offered based on a cumulative examination of up to 4 tax years.

Regarding a taxpayer who does not meet any of the conclusive presumptions, the determination of residency will be based on the center of life test while using the rebuttable presumptions that exist today. In addition, it is proposed to keep the residual definition that anyone who is not a resident of Israel according to all the tests will be considered a foreign resident.

The proposed change has a significant impact that may affect the decisions of many taxpayers regarding their days of stay in Israel.

Foreign tax credit

The memorandum published on September 5, 2023 includes a number of amendments regarding foreign tax credits that are allowed as a credit against the tax calculated in Israel on foreign income. The reform offers relief in receiving credits from foreign taxes in certain aspects, and on the other hand, places limitations aimed at preventing taxpayers from reducing the tax in Israel in a way that does not fulfill the purpose of the legislation.

Amending the definition of "foreign taxes"

The crediting mechanism established in the Ordinance is based on the definition of "foreign taxes" in Article 199 of the Ordinance. The existing definition makes it possible to benefit from a credit in respect of foreign tax that meets the following conditions:

- The tax is paid by a resident of Israel to the tax authorities of a country outside of Israel on income originating in that

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country (including countries that are part of a federal state or regional authorities that are part of that country)

- The tax is calculated as a percentage of the income
- This is not a municipal tax

Within the limits that were placed, it was proposed to add various limits to the definition of "foreign taxes" in Article 199 of the Ordinance, and to expand the tax payments abroad that do not grant a tax credit in Israel. Among other things:

- Taxes paid to the tax authority of: an enemy country, a country with a harmful tax regime (a closed list to be published in the Order), or a country that does not have an information sharing agreement with Israel, other than exceptions
- Taxes for which a credit can be given in another country (other than exceptions)
- Taxes rebated to the payer in the foreign country, or that exceed the minimum tax that the taxpayer might have paid in the foreign country

Indirect credit in respect of a dividend received from a foreign resident company

Article 126(c) and Article 203(b) of the Ordinance establish a mechanism that allows taxpayers to benefit from a credit for corporate tax paid by a foreign company held by an Israeli resident (hereinafter the "foreign company") or its subsidiary, on income from which a dividend has been distributed. The condition for receiving the credit is that the taxable income is calculated at the level of the foreign income before deduction of corporate tax.

Main points of the proposed amendment to this mechanism:

- The mechanism can also be applied to foreign taxes paid by a company that is a grandchild or great-grandchild of the foreign company
- The determination of minimum rates of holding in the foreign company and the companies held by it (the requirement refers to both the effective rate of holding of an Israeli resident and the direct rate of holding of a company in its subsidiary)
- Determining the holding requirement for a minimum period of 365 days before distribution of the dividend as a condition for applying the indirect crediting mechanism. The proposal specifies various conditions and provisions for the applicability / inapplicability of the limit.

Expansion of credit baskets

In Israel, the "basket" method is practiced, where tax paid abroad against income from a specific source is credited against all foreign income originating in the same basket. Today, each of the sources of income set out in Article 2, part E or part E3 of the Ordinance constitutes a separate basket (and includes among others the following sources as a separate source of income: salary, business, interest and dividend, rent,

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royalties, capital gains, etc.). It is proposed to reduce the number of baskets and thus provide greater flexibility in applying a credit for tax paid abroad also to income from a similar source, and not only against the exact same source.

The main baskets proposed:

- Earned income – which includes: business, profession and salary
- Passive income
- Capital income

Special rules have also been established regarding income from a controlled foreign company and a professional foreign company

Surplus credit

Today, if the tax paid abroad exceeds the tax liability in Israel, the excess amount constitutes a "surplus credit" and can be transferred for utilization in the next 5 tax years.

It is proposed **to cancel the possibility of transferring surplus credit to the following years,** except in the case where the excess credit has been created as a result of offsetting losses according to Israeli law which, according to foreign tax laws, could not be offset. **In this case, there will be no time limit for utilizing the surplus credit.**

Additional amendments

A number of additional amendments were specified in the memorandum, including:

- Determining a credit mechanism in cases where the tax date on the income abroad is earlier than the tax date in Israel (this issue may resolve many conflicts in the current legal situation)
- Cancellation of various sections that are not relevant today

The Reform in International Taxation

Controlled foreign company and professional foreign company

Articles 75b and 75b1 of the Ordinance are anti-planning sections whose purpose is to advance taxation in Israel for the income of certain companies abroad that are largely held by Israeli residents.

These articles determine t**he definition and manner of taxation of a controlled foreign company,** known as a CFC, and a professional foreign company, known as a PFC.

The CFC route deals with companies whose main income is passive (among other things: income from rent, interest and dividends, which does not arise from business activity) while the PFC route deals with companies whose main income comes from a particular profession.

In these companies, a taxation mechanism is operated that attributes the company's income to the controlling shareholders, Israeli residents, at the time the income is generated (and not when the profits are distributed as a dividend).

In the memorandum, a number of amendments are proposed to CFC and PFC taxation. Among other things:

- Changing the definition of passive income in a controlled foreign company to "portable income" and expanding the definition to include additional types of income that can be easily moved between countries. For example: income derived from financial instruments, sale of intangible assets that represents income from a business, and more
- Expanding application of the article also with regard to companies that are held by Israeli residents at a lower rate than currently stipulated in the law
- Application of the taxation regime of a controlled foreign company with regard to companies registered in countries with a harmful tax regime, even without meeting the passive income conditions

and more.

Value Added Tax on the import of services to Israel

Import of services / background:

Many of us import services from abroad such as: consulting services, legal services, employment of subcontractors, brokerage, etc. Import of services in Israel may be subject to VAT (Value Added Tax) in accordance with the instructions of the Value Added Tax Law, 5736-1975 (hereinafter the "Law") The Law sets out the conditions and instructions applicable to the import of services to Israel.

VAT on provision of a service – general

The VAT Law applies to every transaction in Israel. The definition of "transaction" includes: "the sale of an asset or the **provision of a service** by a business in the course of its occupation, including the sale of equipment."

In order to be liable for VAT on a service provided, it is necessary for there to be a consideration in money or money equivalent.

In addition, it is necessary for the service to be performed for the benefit of others. Providing service to oneself is not subject to VAT, (unlike inventory – turning business inventory into private use is subject to VAT as a sale in every respect).

VAT on the import of services to Israel

Article 15(a) of the Law extends the charge of VAT also with regard to the import of services. In accordance with the provisions of the article, a service will be considered to be provided in Israel when there is a connection between the service and an Israeli resident. The article examines three criteria, where if one of them is met, the service is considered to be provided in Israel and will be charged with VAT:

(1) Where the service is rendered

(2) The recipient of the service

(3) For what purpose was the service given

A service will be considered a service imported to Israel if it is actually used in Israel, intended for use in Israel, or provided in connection with an asset located in Israel.

Examples:

- Broker abroad brokering a property located in Israel
- Architectural services provided from abroad to an Israeli resident
- Lecturer abroad giving a lecture in Israel

Taxation Decision 7215/16 – VAT liability for services received from a foreign resident and utilized abroad

A company resident in Israel is registered for VAT purposes as a licensed business. The company

Value Added Tax on the import of services to Israel

received services from foreign service providers: transaction accompaniment services and payment for a trust company to accompany the sale of shares.

In the framework of the decision, a distinction was made between banking services to accompany the transaction given and utilized abroad, for which VAT is not charged, as opposed to trust company services utilized in Israel, which will be charged VAT.

How to report and pay the tax:

In general, Article 16 of the Law states that the obligation to pay the tax when providing a service applies to the service **provider**.

Regulation 6d

Regulation 6d requires the buyer (recipient of the service, Israeli resident) to pay the tax and not the seller (the service provider, resident abroad), unless the seller has issued him an invoice.

If the importer **is a business**, the report will be made through a **"self-invoice"** as part of the current reports on its transactions, and it will pay the tax due when the current report is submitted.

If the importer **is not a business**, the import will be reported in the manner that a **commercial venture** must be reported as stated in Regulation 15a(a) and (b) of the Value Added Tax Regulations, 5736 - 1976, and will pay the tax due upon submission of the report.

Taxation Decision 6369/18 – summary tax invoice for the import of services and intangible assets

The taxation decision facilitates the reporting and payment of the tax on the import of services in cases where the obligation to report according to Regulation 6d of the regulations applies to a large number of payments. In accordance with that stated in the decision, it is possible to issue a "summary self-invoice" once a month in respect of the consideration paid to the foreign suppliers during that month for import of the services, provided that all the specified conditions are met. **Any business that considers itself to be in compliance with the terms of the arrangement described in the decision may act accordingly.**

Zero rate VAT on the provision of services to a foreign resident

General:

In order to encourage the export of services from Israel, Article 30(a)(5) of the Value Added Tax Law, 5736-1975 (hereinafter the "Law") states that the provision of service to a foreign resident in Israel will be subject to zero rate VAT. This article is an advantage for businesses because charging zero VAT enables the inputs tax used in the business to be deducted.

Article 30(a)(5) Providing service to a foreign resident

In the article it is established that, as a general rule, when providing a service to a **foreign resident**, VAT will be applied at a zero rate.

Definition of foreign resident in Article 1 of the law:

(1) Regarding an individual – an individual residing permanently outside of Israel;

(2) Regarding a body of persons – a body of persons registered or incorporated only outside of Israel

There are three exceptions to this article that are defined in the article and in Regulation A12 of the VAT Law, which have in common a connection to Israel in the provision of the service. In each of the exceptions, VAT will apply at the full rate even though the service is provided to a foreign resident:

1. "A service will not be considered a service to a foreign resident when the subject of the agreement is the provision of a service in practice to an Israeli resident in Israel," that is, when an agreement is signed with a foreign resident that the service will actually be provided to an Israeli resident who is in Israel, zero rate VAT will not apply."

For example: A foreign resident orders counseling services for his son who is a resident of Israel.

Caveat

When the service is actually provided to an Israeli resident in Israel, but the price is part of the price of an imported asset, then a zero rate will apply.

2. **Regulation 12a(a)** states that the provision of a service to a foreign resident regarding **an asset located in Israel** will be subject to VAT at the full rate (other than exceptional cases as detailed in the regulation).

For example: A broker brokering an asset located in Israel for a client abroad.

3. **Regulation 12a(c)** states that when a service is provided to a foreign resident and the foreign resident is a tourist, zero rate VAT will not apply (in certain cases, VAT will be applied at zero rate by virtue of Article 30(a)(8)).

We will be happy to be at your service!
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