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SPECIAL REPORT

Corporate Services Providers Beware: Israel Targets Offshore Companies

by Yaron Sever

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In this article, the author discusses recently proposed legislation in Israel regarding the tax filing obligations of offshore companies.

According to legislation recently proposed by the Israeli government, certain offshore companies in which Israeli tax residents hold 50 percent or more of any means of control will be presumed to be Israeli tax resident companies subject to tax (24 percent) and filing requirements in Israel.

Proposed Amendment 238 to the Income Tax Ordinance targets companies organized in offshore jurisdictions with attractive tax regimes. It applies to any company that is subject to a corporate income tax rate of less than 15 percent in its jurisdiction of residence and is either a resident of a country that does not have a double tax treaty with the State of Israel or a country that has a territorial tax system (that is, a corporate income tax limited to domestic-source income). The proposal, which has attracted significant media attention in Israel, is expected to receive final approval from the Israeli parliament and be enacted into law during 2017.

The proposed legislation is a major shift in the tax treatment of foreign companies. Under current Israeli tax rules, a company that is not incorporated in Israel is considered an Israeli resident for Israeli tax purposes only if its business is ''controlled and managed'' in Israel. This test has been the subject of frequent interpretation in recent years, both by the Israel Tax Authority and Israeli courts. To increase transparency and battle offshore tax planning, the proposed legislation would amend the ''control and management'' test by inserting a rebuttable presumption. Unless shown otherwise, an offshore company held 50 percent or more by Israeli tax residents would be deemed to be controlled and managed in Israel.

The amendment thus shifts the burden of proof for the ''control and management'' test from the tax authorities to the taxpayer. At best, from the viewpoint of the company, it would be required to file a tax return in Israel annually to provide the information and supporting documentation necessary to rebut the presumption. At worst, if the offshore company did not successfully rebut the presumption, it would be brought into the Israeli tax net.

Further, according to the proposal's explanatory notes, in some cases, the Israeli tax authorities may consider a company Israeli resident even if Israeli tax resident shareholders hold less than 50 percent of its means of control.

If enacted, Amendment 238 could affect tens of thousands of companies in various offshore jurisdictions, requiring them to file tax returns in Israel for the first time. Ultimately, it may result in many of these companies paying Israeli taxes. In some cases, when the companies are actually managed and controlled in Israel, this may be rightly so. In other cases, the company might file and even pay Israeli taxes just because the company, or its service providers acting as directors, does not wish to challenge an aggressive position taken by the Israeli tax authorities.

The proposal could have a significant impact on offshore service providers that hold positions as directors

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or other officers in offshore companies. Despite acting outside Israel, they may be subject to both criminal and civil liability if the company does not meet its filing obligations. This is because the proposed filing obligation falls on the company, not the company's shareholders. Companies should consider this risk when deciding on the best course of action in the face of this new proposal.

This is not the first time Israel has sought to impose tax reporting and potential tax payment obligations on non-Israeli service providers. The Israeli law on the taxation of trusts, in force since 2006, similarly imposes reporting and tax obligations on the trustee of a non-Israeli trust with an Israeli beneficiary, irrespective of the residency of the trustee.

If the new law is enacted, corporate service providers are likely to consult Israeli tax advisers on what evidence a company will need to provide to the Israeli Tax Authority in order to rebut the presumption.

Personal Residence Test

The Israeli tax authorities recently used the same tool — requiring disclosure and shifting the burden of proof — in the context of residency issues outside the corporate world.

The most notable example is Amendment 223 to the Income Tax Ordinance, published April 7, 2016. It requires individuals who meet a day count presumption of physical presence in Israel to file a return and attach supporting documentation if they wish to claim non-Israeli tax residency. This amendment first applies to tax returns to be filed for the 2016 tax year.

By way of background, Israeli tax rules determine personal tax residency using a broad facts and circumstances test that focuses on the individual's ''center of life.'' The tax authorities determine the center of an individual's life by considering various elements taken together, such as the location of the individual's ''permanent home'' (the residence that is available to the individual and his family at any time during the year); the location of the individual's regular or permanent place of business, employment, or other economic ties; the place where the individual is active in organizations and institutions; and, generally, where the individual has social ties.

There also is a rebuttable presumption that an individual's center of life is in Israel if a physical presence test is met. Under the day count test, an individual's center of life is presumed to be in Israel if either he is in Israel 183 days or more during the relevant tax year, or he is in Israel 30 days or more during the relevant tax year and for a total of 425 days or more during the relevant tax year plus the two preceding years. The individual can, however, rebut the day count presumption. If an individual can prove that his center of life is not in Israel, he will not be viewed as an Israeli resident despite meeting the day count test.

Until Amendment 223 was enacted, individuals asserting that they were not Israeli residents despite meeting the day count test were not required to notify the ITA or substantiate this position. Since the amendment took effect, a taxpayer who meets the day count test but takes the position that he is not an Israeli tax resident must disclose this position and provide evidence (including supporting documentation) in support of the assertion. Failure to comply with this requirement makes the individual subject to penal sanctions. As with proposed Amendment 238, Amendment 223's requirement to disclose a position contrary to the tax law's presumption will likely affect many individuals. On one hand, it will force those who truly qualify as Israeli tax residents but have not been complying with Israeli law to comply with their tax obligations. On the other hand, individuals who have a valid position contrary to the presumption may be swept into the Israeli tax net simply because they fear disputing the position of the Israeli tax authorities or cannot afford to do so.

In another recent effort to increase compliance, the Israeli tax authorities have started sending out general information request letters to individuals who seemingly meet criteria rendering them ''suspicious'' in the eyes of the tax authorities. The criteria for this categorization have never been published, and many see this process as a fishing expedition. The letters require the individuals to supply specific information, including the nature of their assets, the source of their income, and their tax status. Again, this is a case of shifting the burden of proof to the taxpayer to demonstrate that he is complying with the law, without any tangible information from the tax authorities indicating otherwise.

Israel's Changing Tax Landscape

Amendments 238, 223, and the request for information letters show a clear attempt by the Israeli Tax Authorities to impose increased transparency on companies and individuals connected to Israel. The country only moved to a system of worldwide taxation in 2003, with a special regime for new or returning residents. Unlike in many countries, Israeli tax residents are generally not required to file annual income tax returns because their tax liability is withheld at the source by the banks and employers.

Slowly but surely, the Israeli government and tax authorities — as part of the OECD and sharing the OECD's commitment to the global fight against tax avoidance — are increasing the reporting obligations for both individuals and companies. More changes are coming, but the process has begun. ◆

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