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Israel Amends Controlled Foreign Corporation Tax Regime

by Henriette Fuchs

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Israel's Knesset on December 23 approved amendment 198, revising section 75B of the Income Tax Ordinance, 1961 (ITO) to further ensure the taxation of controlled foreign corporations. The amendment entered into force on January 1.

Since 2006 Israel has taxed qualifying resident shareholders -- both corporate and individual -- on the undistributed profits of foreign companies that qualify as CFCs. Specifically, when an Israeli resident shareholder individually owns at least 10 percent of the means of control of a foreign company and collectively owns, together with other Israeli resident shareholders, at least 50 percent, and the majority of the foreign company's income is (by Israeli definition) considered passive in a specific tax year, the qualifying shareholders must each report their pro rata part in the undistributed profits of that foreign company as a deemed dividend. That regime also applies to foreign companies that are controlled at least 40 percent by close relatives.

The CFC legislation applies to the profits of a foreign company that are effectively taxed in a country that Israel considers to be a low-tax jurisdiction. Since the inception of this legislation, however, the tax authorities have become aware of the need to reexamine ITO section 75B.

Several changes to that regime have been enacted under amendment 198.

The profits of a CFC located in a country with which Israel has an income tax treaty will continue to be calculated in accordance with the tax rules in that other country. However, from 2014 onward, the calculation of the undistributed profits of the foreign company must include dividends and capital gains, even if those items of income are not included when calculating taxable income under the rules in the other country.

When that country's tax rate applicable to the foreign company's passive income is under 15 percent, the company must report a deemed dividend. (Previously, the minimum rate of foreign corporate tax that would disqualify a foreign company from being a CFC was 20 percent.)

The option of claiming a foreign tax credit to offset the Israeli tax on deemed dividends has been canceled. An FTC now can be claimed only in the year that the foreign tax is paid, most likely in the year of actual distribution. When a shareholder in a CFC reports a dividend and is not able to fully offset the foreign tax incurred on actual distributions in the same year, the shareholder may be eligible for a refund of any taxes paid on the deemed dividend in previous years.

When considering the nature of a foreign company's income, the dividends it receives will not be characterized as passive income if the profits that produced the dividends were taxed at a rate higher than 15 percent and if the receiving company

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holds at least 5 percent (directly or indirectly) in a paying company that is traded on a stock exchange outside Israel, or at least 10 percent in all other cases.

For the purpose of determining the means of control in a foreign company held by a resident shareholder and his relatives, the definition of "related shareholders" now includes "foreign bodies considered related," as defined in ITO section 88. Israeli resident shareholders that are considered together with foreign related parties may therefore have a qualifying stake (more than 40 percent) in the means of control in a foreign company, potentially making it a CFC.

A foreign company's income from the sale of securities now qualifies as passive income. However, if the securities sold were held for less than one year and were an integral part of the business run by the company, income from their sale will not automatically be considered passive.

When calculating taxable capital gains, a qualifying Israeli resident shareholder selling all or some of his means of control in a CFC may deduct from the price received any related income reportable as a deemed dividend during the same tax year. The calculation of the amount of the deduction is to be performed on a pro rata time basis in relation to the period of ownership of the shares sold, from the beginning of the tax year until the date of sale.

The minister of finance has been given the authority to determine that some additional deductions from, or exemptions of, income -- as may be allowed in the country of residency of the foreign company for tax purposes -- should be added back into the foreign company's income when calculating its undistributed income. Expenses or deductions that would not be allowed under generally accepted accounting principles would likely be subject to such scrutiny.

Henriette Fuchs, partner, Barnea & Co. Attorneys at Law, Herzelya, Israel

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