

Controlled Foreign Companies (CFCs) in Israel following the Income Tax Reforms

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I. General Overview

The tax reform in Israel which became law on 1st January 2003 changed the tax regime from territorial taxation to personal taxation. Effectively, an Israeli resident is now taxable on his worldwide income.

The change of the tax regime required new laws to be drafted in order to prevent situations where Israeli residents could 'transfer' their passive income derived from overseas (e.g. interest, dividends, royalties, rent and/or capital gains) to foreign companies controlled by themselves, and thereby avoid paying tax in Israel. By 'transferring' passive income to foreign companies, an Israeli resident could have benefited in two ways: Firstly, not being taxed in Israel on the income of the foreign company (in specific circumstances) and secondly, being able to delay the taxation of the dividends distributed by foreign company until actually received by the tax payer (Israeli resident). In order to overcome this problem, the tax Reforms introduced regulations in Section 75(B) of the amended Income Tax Ordinance ('the Ordinance').

II. Section 75(B) of the Ordinance

Section 75(B) introduces the concept of '*deemed dividend*', which is common in other jurisdictions. The purpose of '*deemed dividend*' is taxing the controlling members of the CFC who are Israeli residents as if dividends were actually distributed to them.

Section 75(B) states that 'if a controlled foreign company has unpaid profits, then its controlling member shall be treated as if he had received his proportional share of those profits as a dividend'.

The CFC laws therefore introduce the concept of '*deemed dividend*' to controlling members (Israeli residents holding 10% or more of the means of control) for unpaid profits of controlled foreign companies of which 50% of the control is being held by Israeli residents. This concept effectively introduces a system of settling the payment of tax in advance. Tax will be charged if at least 50% of the company's profits in a tax year originated from passive income generated overseas and which were taxed overseas at a tax rate not exceeding 20%. The result will be levying tax in Israel on an annual basis, for the '*deemed dividend*' of the passive income of Israeli residents holding over 10% of the means of control in the CFC.

III. What are the characteristics of a CFC?

Section 75(B) describes a CFC as a foreign resident 'body of persons' for which all of the following hold true:

1. Its shares or the rights in it are not listed for trading on a Stock Exchange;
2. Majority of its income (over 50%) in the tax year is passive income or most of its profits derive from passive income (i.e. income from interest, dividends, royalties, rent and consideration for the sale of an asset which was not an asset used by the company in business or in an occupation).

Example: A foreign company under control of Israeli residents has business income of \$100m and passive income from dividends / interest of \$100,000. Although the company makes a profit of \$50,000 on its business income, it makes a profit of \$75,000 on its passive income. The result will be that the CFC rules will apply on controlling members of this company who are Israeli residents (as most of its income (over 50%) is passive income).

What constitutes passive income?

Passive income is defined in Section 75(B) as each of the following kinds of income, if it is not income from business or occupation:

- Income from interest;
 - Income from dividends;
 - Income from Royalties;
 - Income from Rent;
 - Consideration for the sale of an asset which was not an asset used by the company in business or in an occupation; and
 - Any income that stems from an income or a consideration from the above, even if it is income from business or occupation.
3. The tax rate that applies to the CFC's passive income overseas does not exceed 20%.
 4. More than 50% of one or more of the CFC's means of control are directly or indirectly held by Israeli residents or by Israeli citizen, or over 40% are held by Israeli residents, who together with a relative (also a foreign resident) of one or more of them hold more than 50% of the means of control; or an Israeli resident has the right to prevent adoption of substantive management decisions in it (including decisions on dividend distributions or on winding up) whether the means of control are by way of shares or other means, including a trust.

'Means of control' are defined as each of the following:

- The right to participate in profits;
- The right to appoint a director;
- The right to vote;
- The right to part of the balance of assets of the body of persons at winding up after its debts were paid;

- The right to order a person who has one of the rights above how to use that right.

IV. CFC Tax Arrangements in Israel

1. 'Deemed Tax Credit'

Section 75(B) states that when calculating tax due by a controlling member of a CFC, a 'deemed tax credit' shall be granted to him in the amount that would have been deducted at source by the CFC's jurisdiction, as if the dividend was actually distributed, but not exceeding the tax payable in Israel. Therefore, tax paid overseas 'in excess' will not be returned / credited in Israel. There also exist other limitations concerning the recognition of the deemed tax credit where the CFC is resident in a not reciprocating jurisdiction.

2. Actual distribution of dividends

Section 75(B) states that when dividends are actually paid out by the CFC to an Israeli resident controlling member out of already taxed profits, he shall be granted a credit in the amount of the tax paid on these profits.

3. Selling shares in the CFC

A controlling member selling all or some of his means of control in a CFC, shall be exempt of the tax that applies to the sale in the amount of the tax he paid in preceding tax years on unpaid profits in respect of the means of control that are being sold, and which had not been distributed as dividends until the date of the sale.

The amount of tax paid in preceding tax years shall be adjusted according to the index increase from the end of the year in which it was paid until the date of sale of the means of control.

V. CFCs: tax efficient structures?

There are several instances where the use CFCs may be beneficial. For example, until 31 December 2006, an Israeli resident can invest in foreign securities through a CFC and thereby reduce capital gains tax liability from 35% to 25% and also benefit from other advantages.

There are several situations where the CFC rules may not apply, for instance:

1. By using the CFC as an active business company, the company's income will derive from business or occupation and will not be treated as passive income and the CFC rules will not apply.
2. Alternatively, where the CFC's income is mostly passive income, one can increase the level of business activity in the CFC and thereby avoid the CFC rules.
3. The CFC can be incorporated in a jurisdiction imposing a tax rate of over 20% and thereby delay payment of tax to the actual date of distribution of dividends.

4. The CFC rules may not apply when less than 50% of the company's shareholders are Israeli residents and also where each one of them holds less than 10% of the means of control.
5. In our opinion, under the Israeli current tax law, the CFC rules may not apply where at least 51% of the rights in the CFC are held by an irrevocable discretionary trust.
6. Furthermore, Israel's tax treaty with Singapore states that distribution of dividends from a Singapore company to an Israeli company may in certain circumstances will be exempt of tax in Israel. Therefore, we believe that the Israeli company may not be subject to a 'deemed dividend' under the CFC rules.

VI. Conclusion

The tax reforms in Israel introduced new CFC laws, which inter alia attempt to prevent Israeli residents from avoiding taxes on their passive income from overseas sources by transferring the income to foreign corporations. It still remains to be seen how case law will interpret the rules of CFCs and how they will affect Israeli residents in practice.

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