

# ליאור פיק ושות' – משרד עורכי דין

## **Lior Pick & co. Law offices**

19 Rothschild Blvd. Tel-Aviv      שדרות רוטשילד 19 תל-אביב  
P.O.Box 16003 Tel-Aviv 61160, Israel      ת.ד. 16003 תל-אביב 61160, ישראל  
Fax: + 972 (3) 5105025 : פקס      Tel: + 972 (3) 5105005 : טלפון

*E-mail: Picklaw@012.net.il*

**Lior Pick Adv. (CPA (Isr.))**  
**Merav Barinshtein, Adv.**  
**Adi Rozenfeld, Adv.**

ליאור פיק, עו"ד (רו"ח)  
מרב ברנשטיין, עו"ד  
עדי רוזנפלד, עו"ד

## **Tax Exemption for Foreign Resident Deposits**

**Lior Pick, Adv. (C.P.A. (Isr.)) TEP<sup>1</sup>**

1. The 132<sup>nd</sup> Amendment of the Israeli Income Tax Ordinance (here and after referred to as "the Tax Reform Law" and "the Ordinance") introduced dramatic changes to Israeli taxation system. Pursuant to the tax reform, in connection with foreign residents deposits, some new provisions were introduced, which were not included originally in the Report of the "Rabinovich Committee", and it is possible that the expected damage of these new provisions does not justify their benefit. In this essay we have chosen to focus on the novelties regarding tax exemption for foreign residents' deposits.
2. As of January 1, 2003, foreign residents will be liable to tax in Israel provided that they have income derived and/or accrued in Israel. Paragraph 4A of the Ordinance contains rules of origin list, according to which the income of interest is accrued in Israel if the payer is located in Israel. In other words, the interest income in the hand of non-resident from a corporation located for the fiscal purposes in Israel will be taxed in Israel.

---

<sup>1</sup> Lior Pick & Co. Law Offices

3. On the other hand, since the State of Israel, similarly to other states, is willing to attract foreign investments to Israel, for years interest income of foreign residents accrued from bank deposit was exempted from income tax. According to Income Tax Order (Tax Exemption of Foreign Residents' Deposit) of 1981, which has replaced the Order of 1961, the interest incomes which are paid by the state or by the authorized dealer (based on the definition in the Israeli Law of Foreign Currency Regulation) are exempted from income tax, provided that it is a deposit of non-resident, who is not running a business or vocation in Israel.
4. Pursuant to Income Tax Order (Tax Exemption of Foreign Residents' Deposit) of 2002, the order from 1981 was revoked, and the new order stated instead that interest which is paid to the foreign resident on the basis of a deposit in foreign currency at General Accountant or by banking corporation will be exempted from taxation, provided all of the following conditions:
  - a. The deposit is not registered (and its registration is not required) in the books of a Permanent Establishment in Israel and the interest income is not a business income;
  - b. Israeli residents are not partners in the deposit;
  - c. Foreign resident has declared of his foreign residency;
  - d. The deposit is not used as loan or as a guarantee for a loan from a banking corporation to a relative of foreign resident or to a body of people which is controlled by the foreign resident (according to the definition in the paragraph 32(9) of the Ordinance, meaning 10 percent directly or indirectly, by himself or together with his/her relative (who can be a foreign resident as well)), if they are Israeli residents.
5. exemption, and it is apparently designed to serve two primary goals: first, denial of the indirect benefit in the form of exemption of interest income as stated above from the foreign residents; and second, prevention of the possibility of receiving Back to Back loans as a part of tax planning by foreign residents,

while the exempted deposit constitutes a guarantee for a loan in the business level by foreign resident in Israel.

For instance- foreign resident places 1,000,000\$ in foreign resident deposit under an annual interest of 5% (exempted of tax) and a company controlled by him received a loan from the bank under the same conditions. On the individual level, as a foreign resident he accumulates exempt annual interest of 50,000\$, while on the other hand, the same amount is allowed for deduction as an expense of his company. The tax saving accruing from this action is in the rate of 36% for the company plus 25% of the dividend, since this is a net interest gained by an individual.

6. Prior to the tax reform, this kind of planning was accepted and widespread in business corporations owned by foreign and/or Israeli residents, since until recently the interest of the deposit and/or saving account program in the bank was exempted from the tax.
7. Today, in the light of Tax Reform Law, personal interest of Israeli resident is subject to tax in the rate of 10 percent (nominal) or 15 percent (linked), and the gap between taxation of savings interest and the company tax is small, but still significant (saving up to 40 percent) and it is exploitable by the holder of controlling interest.
8. On the other hand, the legislator has chosen for foreign residents to harden and to worsen the requirements for tax exemption of the deposit interest as mentioned above. Thus, for example, as stated above, a declaration of foreign resident is required; a foreign resident is required to avoid providing security and / or a loan to his relative who is an Israeli resident, to avoid using the deposit as a guarantee for business credit in Israel and more. The examination of these new bureaucratic conditions and the restrictions above shows that

comparing to the benefits expected from this exemption (saving of 10 to 15 percent tax on the interest after the tax reform). Moreover, adding bureaucratic and substantial conditions as requirements for the exemption, as it has been done by the new order, may to our opinion force the foreign residents to transfer their deposits to foreign banks, in the states where the tax exemption is not that stringent and where it is possible to provide the deposit money as a guarantee against business credit for the Israeli company controlled by foreign resident. In that manner, the deposit money will invest outside of Israel, interest incomes will be further exempted from taxes, and interest expenses paid by the business corporation in Israel to the foreign bank would be deductible.

9. The deduction at the source of the interest will not prevent that, as several Double tax treaties signed by Israel provide withholding tax at a minor rate between zero (0) and five (5) percent only (as in Hungarian bank interest in 0 percent, and in Irish, Swiss, Spanish and Polish banks the withholding tax of that interest is five (5) percent only). There are, of course, other possible sophisticated planning's to overcome the conditions set by the order of exemption, such as use of mutual fund for foreign residents and /or a deposit in foreign international bank with local branch in Israel and more.
  
10. Finally, we should note that the Income Tax Commission and the legislator have worked extensively to complete the new complex legislation of the current tax reform in short, almost unthinkable periods of time. Nevertheless, several failures rise from the Reform Law and the secondary legislation, and these failures may cause damage to Israeli economy generally and to Israeli banks in particular, damage which may become irreversible, and which should be repaired promptly.

11. It is a known fact that creative solutions exist, making it possible to override some of these failures in tax legislation, but there are some typical cases, as the described above, which require the attention of the legislator and immediate amendment.

**All the stated above is a general review only, and it is by no means a legal advice and/or a substitute for legal advice. It is recommended to acquire professional advice in every particular case.**

*Lior Pick & Co. Law Offices specialize in International Taxation, Tax Planning Income Tax, VAT, Corporate Law, Securities, Real Estate and Litigation.*

*Lior Pick is secretary of the Israeli branch of the STEP organization.*