Israel's Tax Treaties - an Important Instrument to Encourage Foreign Investments

It is common to refer to double tax treaties as a form of agreement between two or more countries, which allocates the taxation rights between them. The earliest tax treaty was concluded between Belgium and France in 1843. However, it is only in the 20th century that tax treaties, in the form which is familiar today, became widely used. It is estimated that today, there are approximately 1700 tax treaties around the world.

It is commonly argued that the main purpose of tax treaties is the avoidance of double taxation. At the same time, there are scholars who emphasize other purposes. For example, it is claimed that the purpose of tax treaties also includes the prevention of tax avoidance, the prevention of tax discrimination, the improvement of tax collection and the promotion of certainty as to the taxes imposed. However, there is one undisputable fact – tax treaties, whatever their purpose, are critical instruments within the process of globalization.

Israel wishes to be an integral part of the new global world order. Accordingly it consistently continues to develop its tax treaties and to initiate negotiations with countries from all around the world. The first tax treaty to which Israel was a party, was concluded with Sweden in 1959. At present, Israel is a party to a wide range of double tax treaties within approximately 41 jurisdictions (3 of which have not yet been ratified). In addition, Israel has signed an agreement with the Palestinian Authority, which also includes tax matters and which in some respects can also be regarded as a tax treaty. Furthermore, in addition to tax treaties, Israel has also concluded 14 social security treaties mainly with western countries. Most of Israel's tax treaties are based on the OECD Model Tax Convention.

The State Revenue Division and the Tax Commissioner at the Ministry of Finance are responsible for negotiating new tax treaties. Tax treaties to which Israeli is a party, are signed by the Foreign Minister or by the relevant Israeli ambassador pursuant to a special power of attorney. A tax treaty must be ratified by the Government and then by the Minister of Finance who issues a special order by which the treaty comes into force. Tax treaties that have been ratified by special order of the Minister of Finance have priority over domestic tax law. Consequently, if there is a conflict between a provision of domestic Israeli tax law and a provision of a tax treaty, the tax treaty provision prevails.

It should be noted that a tax treaty cannot create new tax rights. Accordingly, even if a tax treaty states that Israel is entitled to tax income of a certain kind, but according to domestic law, such income is exempt from tax, the income will be exempt from tax notwithstanding the relevant treaty provisions.

The Israeli courts have not yet developed any significant decisions with regard to Israeli tax treaties. In fact, there is only one decision of the Israeli District Court which deals with Israeli tax treaties. This case was published recently and deals with the mutual agreement procedure in the tax treaty between Israel and Japan. In a nutshell, it was held that mutual agreement procedures should be implemented prior to judicial procedures before the Israeli court. Thus, the court stayed the judicial proceedings and ordered the Israeli Tax Authorities to determine whether it should commence the applicable treaty procedures with Japan.

Israel has never formally published its policy with regard to the conclusion of tax treaties. However, from "informal sources", it may be inferred that when concluding its tax treaties Israel not only takes into account the strict aspects of tax collection and allocation, but also regards its tax treaties as a tool for the promotion of Israel's economic interests, such as the promotion of foreign investment.

In order to encourage foreign investment, Israel is generally willing to waive its taxation rights and to provide foreign investors with a wide range of tax incentives. For example, Israeli domestic law states that capital gains deriving from the sale of traded securities, as well as from the sale of certain R&D companies, are tax exempt in the hands of foreign investors. Similarly, foreign investors in Israeli venture capital funds can obtain special tax rulings according to which their income from such funds is tax exempt. In waiving its taxation rights and reducing its tax revenues, Israel hopes that foreign investments will promote the local economy, in particular through capital investment in economically under-developed zones, job creation and improvement of Israel's foreign currency reserves.

It is thus generally believed that the tax treaties which Israel concludes are important instruments in its efforts to encourage foreign investment. When negotiating its tax treaties, especially with developed countries, Israel sees itself as a "developing" country whose main interest is to promote foreign investment by reducing the taxation of foreign investors under the applicable treaty. This attitude can be illustrated by a number of provisions of Israel's tax treaties. In this article, we have chosen to focus on some main provisions, which include the tax sparing provisions, capital gains provisions and passive income provisions.

Tax Sparing Provisions in Israel's Tax Treaties

The strongest evidence that Israel wishes to encourage foreign investment through its tax treaties can be found in the tax sparing provisions of its tax treaties. Tax sparing provisions are mainly to be found in tax treaties between developed and developing countries. Such provisions require the country of residence to credit taxes that have not been actually paid in the country of source on the basis that the tax in the country of source was exempted under a specific tax exemption. Thus, tax-sparing provisions allow foreign residents to enjoy the full benefit of tax exemptions granted in the developing country. In the absence of such provisions, a foreign resident who receives tax benefits in the country of source, will have to pay full tax on the income in question in his country of residence since there will be no foreign tax to be credited against that tax. In such a case, the tax benefits in the country of source will be of little, if any, value to the foreign investor and the country of source will, in effect, be subsidizing the country of residence.

Since Israel provides foreign investors with various tax benefits under its domestic tax laws, it seeks to include tax-sparing provisions in its tax treaties. Accordingly, Israel has tax-sparing provisions in 19 (i.e. almost half) of its tax treaties.

Capital Gains from the Sale of Ordinary Companies

Another method of encouraging foreign investment in Israel may be found in the capital gains articles of Israel's tax treaties and especially in the provisions relating to the taxation of capital gains deriving from the sale of Israeli companies (other than real estate companies). Many of Israel's tax treaties provide that only the country of residence is entitled to tax capital gains deriving from the sale of such companies. Thus, the sale of an Israeli company by a resident of a foreign treaty country will generally be tax exempt in Israel. Examples of such provisions can be found in Israel's tax treaties with the UK, Belgium, Netherlands, Germany, Denmark, Poland, Sweden Switzerland, Canada etc.

Some of Israel's treaties limit the tax rate which Israel can impose on the sale of an Israeli company (e.g. the tax treaties with Austria, Italy, France and Finland). Other treaties give Israel taxation rights only in a case where the foreign resident holds more than 10% of the rights in the Israeli company (e.g. the tax treaties with U.S, Ireland, Greece, etc.), while some treaties provide Israel with the right of "first bite" without any limitation (e.g. the tax treaties with Japan, Czech Republic, Singapore).

In light of the above, it can be concluded that in many situations, foreign investors resident in treaty countries who dispose of their holdings in an Israeli corporation will be exempt from tax altogether or subject to low tax rates in Israel.

In addition, it can be argued that most residents of countries which have tax treaties with Israel are exempt from tax on capital gains derived for the sale of indirect rights in an Israeli company (e.g. shares in foreign company which holds an Israeli company). Under Israel's domestic tax rules, foreign residents who dispose of indirect rights in Israeli assets are subject to tax in Israel. However, when a foreign resident of a treaty country disposes of such indirect rights, it can be argued that, at least in the case of the majority of Israel's tax treaties, Israel cannot tax the foreign resident on any capital gain on that disposal of indirect rights.

Although this issue has never been addressed by the Israeli courts, there are very convincing arguments to support it. These arguments are mainly based on principles of treaty interpretation in general and, in particular, the interpretation of treaties within the context of the Vienna Convention. It should also be noted that in a similar case which was decided in Australia (the *Lamesa Holding BV* case), it was held that if the treaty does not explicitly state that one country has taxation rights over the indirect sale of assets, then it will not have such rights.

Tax Withholding from Passive Income

In the absence of a tax treaty, Israeli residents who pay passive income to foreign residents (e.g. dividends, interest and royalties) are usually obliged to withhold tax at the rate of 25%-34%. However, most of Israel's tax treaties significantly reduce this rate of withholding tax. The following table sets out the withholding tax rates on passive income under a representative sample of Israel's tax treaties with Western countries:

Country	Divided	Interest	Royalties
Austria	25%	15%	10%, 0% in the case of any copyright of literary, musical or artistic creation except cinematograph and television films.
Italy	15%, 10% (if the recipient is a company which holds at least 25% of the capital of the company which pays the dividend)	10%	10%, 0% in the case of any copyright of literary, artistic or scientific work except cinematograph and television films.
Ireland	10%	10%	10%
United Kingdom	15%	15%	0%, 15% with regard to

			television and cinematograph films.
United States	25%, 12.5% (generally if the recipient is a company which holds at least 10% of the voting rights of the company which pays the dividend)	17.5%	10%, 15% with regard to “Industrial Royalties”
Belgium	15%	15%	10%
Denmark	25%	25%	10%
Germany	25%	15%	5%, 0% in the case of any copyright of literary, artistic musical or scientific creation.
Netherlands	15%, 5% (generally if the recipient is a company which holds at least 25% of the share capital of the company which pays the dividend)	15%	5%, 10% in the case of cinematographic and television films
France	15%, 5% (generally if the recipient is a company which holds at least 10% of the share capital of the company which pays the dividend)	10%	10%, 0% in the case of any copyright of literary, artistic or scientific creation except cinematograph films.
Canada	15%	15%	15%, 0% in the case of any copyright of literary, artistic or musical creation except of cinematograph films.
Sweden	0%	25%	0%
Switzerland	15%, 5% (generally if the recipient is a company which holds at least 10% of the share capital of the company which pays the dividend)	10%	5%

With regard to interest income, it should also be noted that in order to reduce the tax liability in Israel, some treaties (e.g. the tax treaties with the US and France) allow foreign residents pay tax in Israel on the basis of their net interest income (i.e. interest income after deduction of interest expenses connected to loans which financed the loan to the Israeli resident). In such a case, the net interest income is subject to the regular corporate or individual tax rates (in 2005 – 34% for corporations, and up to 49% for individuals).

Conclusion

Despite the fact that Israel is a highly industrialized and high-tech orientated country, as far as tax treaties are concerned, Israel takes the position that it is a developing country. Accordingly, Israel generally seeks to include in its tax treaties provisions that will reduce the tax imposed on foreign investors. This policy is an integral and important part of Israel’s comprehensive policy to encourage foreign investment in Israel. It is widely believed that this policy has proved to be highly successful and has made a significant contribution to Israel’s economy. Foreign investors are and always will be welcome in Israel and form an important part of its economy.

This article was written by Meir Linzen, a senior partner in Herzog Fox & Neeman. Mr. Linzen is the managing partner and head of the tax department.

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