ISRAELI COURT CASE FIRST TO INTERPRET TEN-YEAR EXEMPTION

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Nearly a decade after its enactment, *Talmi v. Kfar Saba Tax Assessor* is the first court case to address the implementation and interpretation of the special residents tax regime for new Israeli residents and veteran returning residents ("New Immigrant Benefits").

BACKGROUND

In honor of its 60th Independence Day in 2008, Israel introduced a special tax regime intended for new Israeli residents and veteran returning residents, beginning as of 2007. The New Immigrant Benefits are intended to encourage diaspora Jews and former Israelis to move to Israel by providing them with substantial tax benefits. Pursuant to the amendment, the tax benefits grant a ten-year tax exemption on foreign-source income produced or accrued outside Israel and income stemming from assets located outside Israel. The New Immigrant Benefits also grant an exemption from any tax reporting requirements with respect to foreign income and assets – meaning that new Israeli residents or veteran returning residents are liable to tax and reporting in Israel during the ten-year period only with respect to income derived from an Israeli source or an asset located in Israeli.

THE TALMI CASE – TAXATION OF NEW AND RETURNING RESIDENTS

In the *Talmi* case, an individual returned to Israel after residing in the U.K. for a period of 20 years. He was employed in the U.K. by E.M.C. (the "Company") from 1994 and continued to be employed by the Company after his return to Israel in 2007. His position after his return was Sales Area Finance Manager for the area consisting of Israel, Turkey, Greece, Cyprus, and Malta.

Three points of controversy arose between the Israeli Tax Authority and the individual:

- The individual claimed that income he received from the Company upon his return to Israel was derived in connection with assets he developed for the Company during the time he resided outside Israel as a U.K. resident. Thus, he contended, the income was foreign income that should not be taxed in Israel during the ten-year exemption period.
- The individual also claimed that the source of the income should be determined by reference to the underlying sales of the Company in each country within the region and not as asserted by the Tax Assessor on the number of days of presence in each location. The basis for his argument was that he was compensated by reference to sales volume and not time spent.

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- Finally, he claimed that the date of his return to Israel was July 1, 2007, when his assignment commenced. The Tax Assessor, however, claimed he returned to Israel on January 1, 2007, which was the first day of the year in which the individual began spending more days in Israel than abroad.

In brief, the court ruled on each of the issues as follows.

- **Income Derived from Assets** – The exemption should be interpreted in a broad sense. If the income being paid bears a substantial connection to foreign assets developed prior to the date on which the individual first became an Israeli tax resident, the income was accrued from a foreign asset.

  The court looked to the legislative intent behind the enactment of the New Immigrant Benefits program. It was designed to encourage the return of individuals. It accomplished this in part by granting an exemption for income accrued outside of Israel. According to the court, the term "assets" should be broadly interpreted. Consequently, work methods, sale methods, financial products, various mechanisms, and so forth developed by an individual during the period of absence from Israel should be considered "foreign assets" when applying the exemption. Having said that, the court determined that the individual failed to prove existence of such assets.

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- **Income Derived from Employment** – The court rules that income should be allocated based on the actual location in which a service was provided. In the absence of any other evidence on the individual's part, adopting the formula set in the 2011 Income Tax Circular, according to which the allocation should be based on the business days spent by the individual in Israel and abroad, is reasonable and acceptable.

- **Date of Commencement of Residency** – The court disagreed with the position of the Tax Assessor. The process of relocating the center of vital interests ("Center of Life") of an individual to a different country does not take place abruptly. Rather, it is a gradual process, maturing over a given period of time. This is relevant to both the commencement and the termination of fiscal residency. When examining the individual's physical presence for each day in 2007, the individual spent only half his time in Israel from January 1 through May 31. However, he spent most of his time in Israel beginning at a certain point in June. In addition, his employment contract began on July 1, 2007. Consequently, the court ruled that the individual's date of return to Israel was July 1, 2007.

CONCLUSION

The New Immigrant Benefits have been in place for nearly a decade, and the ruling in the *Talmi* case is the first to discuss the regime and its interpretation. The court has taken a broad stance, which aims to maintain the original intention of the legislation. Undoubtedly, this is good news for individuals wishing to benefit from the provisions of this tax regime. However, it was a sad day for the taxpayer involved in the case. In sum, the Tax Assessor won regarding this particular taxpayer but may have lost on the issue of broader application, the starting date of residence.