ISRAELI C.F.C. RULES APPLY TO FOREIGN REAL ESTATE COMPANIES CONTROLLED BY ISRAELI SHAREHOLDERS

Author
Daniel Paserman

Tags
C.F.C.
Foreign Investor
Holding Company
Israel
Real Estate

Adv. Daniel Paserman (LL.M, C.P.A.), TEP, is head of tax at Gornitzky & Co. in Tel-Aviv, Israel. Daniel is involved in tax litigation and intricate corporate tax planning – both domestic and cross-border. He also advises new immigrants and returning residents to Israel on taxation and tax exemption issues concerning their global assets and business activities.

INTRODUCTION

Recently, the Supreme Court published its judgment in the matter of *Tax Assessor for Large Enterprises v. Rosebud*, which deals with the interpretation of the provisions of Section 75B of the Israeli Income Tax Ordinance (the "Ordinance") regarding a controlled foreign corporation ("C.F.C."). In the judgment, the Supreme Court overturned a decision by the district court, in a move that is likely to have implications for the activities of Israeli taxpayers outside of Israel, through foreign companies in their control and, in particular, for companies that invest in real estate outside of Israel.

LEGISLATIVE BACKGROUND

In January 2003, a comprehensive reform of the Israeli tax laws was introduced. The reform, *inter alia*, adopted a global personal tax system to replace the territorial tax system previously in effect. According to the new global personal tax system, an Israeli resident for tax purposes is subject to tax in Israel on worldwide income. In addition, the tax legislation set forth a number of anti-avoidance provisions, which were intended to prevent taxpayers from taking advantage of the personal nature of the new law by setting up foreign companies based in low-tax jurisdictions. The main anti-avoidance provision took the form of the C.F.C. regime set forth in Section 75B of the Ordinance. The provision affects a C.F.C., as defined, and an Israeli resident who is a controlling shareholder of that C.F.C. Where the C.F.C. earns passive income in any year and fails to distribute that income to its shareholders, an Israeli resident that is a controlling shareholder will be considered to have received his or her *pro rata* share of the profits as a deemed dividend.

A C.F.C. is a private company that is a foreign resident for tax purposes and is controlled by Israeli residents, where most of its income or profits is derived from passive income and where the rate of tax in the foreign country does not exceed 15%. Passive income includes interest income, income from linkage differentials, dividends, royalties, rent, and proceeds from the sale of an asset, provided that such income does not qualify as business income.

ROSEBUD RULING

In the case at hand, Rosebud (an Israeli subsidiary of a publicly-traded Israeli company) indirectly held a number of companies in Luxembourg through a Dutch company. The Luxembourg entities held other foreign companies that each held a separate parcel of real estate. This structure, in which each company is a special purpose vehicle that holds only a single asset, is a common structure in the real estate sector. This structure has many business advantages that do not arise from tax considerations, including (i) limitation of liability, (ii) financial benefits, and (iii) the possibility of selling assets separately – whether directly or through the sale of shares.

In Rosebud, assets and shares were sold. Rosebud claimed that the provisions of Section 75B of the Ordinance did not apply, because the matter concerned business income, which is not passive income. Thus, the question arose as to whether the sale by a company of its sole asset or the sale of shares of a company constitutes a capital event that generates a passive profit for purposes of Section 75B. Rosebud argued that its activity should be examined as a whole and that the group's operations, which include the development, management, appreciation, rental, and disposal of real estate assets, amount to business activity. Therefore, selling a particular asset out of a wide portfolio should be classified as business income rather than capital gain. In sum, the taxpayer argued that business income is not subject to the C.F.C. provisions and it is of no consequence that, in each transaction, only the sole asset of a company was sold by the company or the shares of a single company were sold by its shareholder.

The Israel Tax Authority, on the other hand, claimed that it is necessary to examine each corporation (asset) separately, without looking at the group of companies as a whole. This has been the position of the Israel Tax Authority since the C.F.C. legislation was introduced, in 2003.

The district court allowed the company's position and ruled that the group's operations should be examined as one business. Consequently, the Israel Tax Authority filed an appeal with the Supreme Court.

The Supreme Court, in an extremely short judgment, ruled that the district court had departed from the fundamental principle of corporate taxation in Israel, whereby each company is a separate tax unit. Thus, the Supreme Court classified the income as passive and ruled that the C.F.C. provisions apply.

CONCLUSION

Beyond the ruling, the Court did not go into an in-depth analysis of the issue, because the Luxembourg companies were insolvent and no further tax revenue would be raised. Although the rationale of the decision is sparse, the ruling is important, as a C.F.C. must be examined based on its own facts, not those of other members under common control.

With respect to Israeli investments in U.S. real estate, it is worth reiterating that the Israeli C.F.C. rules do not apply to a foreign company that is subject to a tax rate of more than 15%. It should be noted that dividends derived from income on which a foreign tax exceeding 15% was paid are also not be subject to the C.F.C. rules, provided that the company receiving the dividend holds at least a 5% interest in the publicly traded company distributing the dividends or at least a 10% interest in a private company. In this respect, if the investment in the U.S. is executed through a C-corporation that is liable for U.S. corporate tax at the standard rate of 21%, the Israeli C.F.C. rules are not expected to apply.