ISRAEL TAX AUTHORITY PROPOSES CHANGES FOR INDIVIDUALS WITH CROSS-BORDER CONNECTIONS

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C.F.C.
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Residence

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INTRODUCTION

The Israel Tax Authority (the "I.T.A.") has proposed major international tax reform (the "Reform") that may have a great influence on the residence of individuals and companies having economic operations in Israel or personal ties to Israel. The reform may influence foreign-resident individuals considering a move to Israel and Israeli resident individuals considering a departure from Israel. This article summarizes the main points relating to individuals

CHANGE IN DETERMINATION OF TAX RESIDENCY OF INDIVIDUALS

As of today, an individual is considered to be an Israeli tax resident if the individual's "center of vital interests" is in Israel. This is a facts-and-circumstances test that examines the individual's family, economic, and social ties. In addition, there are two rebuttable presumptions based on the number of days the individual spends in Israel. Under the presumptions, an individual is considered a resident when

- more than 183 days of presence in Israel exists in a tax year, or
- 30 days or more of presence in Israel exists in a tax year and the total number of days of presence in Israel in the three most recent tax years amount to at least 425 days.

The presumptions can be rebutted, by both the individual and the I.T.A., and the party that wishes to rebut the presumption has the burden of proof as to the country in which the individual's center of vital interests is located.

The Reform introduces the concept of irrebuttable presumptions in order to determine the tax residence of individuals who are present in Israel. Under the Reform, an individual will be considered an Israeli tax resident in any of the following fact patterns:

- The individual stays in Israel for more than 183 days in each of two consecutive tax years.
- The individual stays in Israel for more than 100 days in the current tax year and more than 450 days over the course of the three most recent tax years. This presumption will not apply if the individual stays 183 days or more in a country with which Israel has an income tax treaty in effect (a "Treaty Country") and the individual obtains a certificate of residency from the tax authority of that country.

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- The individual stays in Israel for more than 100 days in the current tax year and the individual's spouse is an Israeli tax resident or the individual with whom a mutual household is maintained is an Israeli tax resident.

At the same time, the Reform introduces conclusive presumptions determining that an individual is a foreign tax resident. Consequently, an individual will be considered to be a foreign tax resident in either of the following fact patterns:

- The individual spends less than 30 days per tax year in Israel during each of the four most recent tax years. In such instance, the individual will be considered a foreign tax resident from the first day of the four-year period. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.
- The individual spends less than 30 days per tax year in Israel during each of the three most recent tax years. In such instance, the individual will be a foreign tax resident from the first day of the second tax year. This presumption applies only if not more than 15 days are spent in Israel during the first month of the first tax year in the measuring period or during the last month of the last tax year in the measuring period.
- An individual and spouse spend less than 60 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period. This presumption will apply only if not more than 30 days are spent in Israel by the couple during the first two months of the first tax year or during the last two months of the last tax year in the measuring period.
- An individual and spouse spend less than 60 days per tax year in Israel during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year. This presumption will apply only if not more than 30 days are spent by the couple in Israel during the first two months of the first tax year or during the last two months of the last tax year.
- An individual and spouse spend less than 100 days per tax year in Israel during each of the four most recent tax years. In such instance, they will be foreign tax residents from the first day of the four-year period, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.
- An individual and spouse spend less than 100 days per tax year in Israel, during each of the three most recent tax years. In such instance, they will be foreign tax residents from the first day of the second tax year, provided they spend more than 183 days in a Treaty Country and obtain a certificate of residency from the tax authority of that country. This presumption will apply only if not more than 50 days are spent by the couple in Israel during the first 100 days of the first tax year or the last 100 days of the last tax year.

The Reform retains the center of vital interests test for cases where the conclusive presumptions are not applicable.

TAX BENEFITS TO NEW ISRAELI RESIDENTS AND RETURNING RESIDENTS

Since 2007, an individual who has become an Israeli tax resident, whether for the first time or after spending considerable time outside Israel as a foreign tax resident, is entitled to material tax and reporting benefits. New Israeli residents and returning residents are entitled to tax and reporting exemptions with respect to foreign income and assets for a period of 10 years, commencing on the date they became Israeli tax residents. The Reform is expected to abolish the exemption from reporting with respect to foreign income and assets, thereby eliminating a contentious issue with the O.E.C.D. and the E.U., but to date, there is no suggestion of any changes to the substantial tax exemption.

EXIT TAX

Israeli tax law imposes an exit tax on an individual who ceases to be a tax resident, which means that the assets of an Israeli who terminates his residency are considered to have been sold on the day prior to the day of departure. Current law allows the postponement of the tax payment until the date of an actual sale. The Reform provides additional reporting obligations on assets and the posting of guarantees by individuals who wish to postpone the tax payment to the sale event. It also cancels the option to postpone the tax payment in certain circumstances. The proposals are as follows.

If the value of the assets subject to exit tax as of the date of departure is less than NIS 3 million (approximately €840,000 as of November 30, 2021), the taxpayer may elect to postpone the tax payment to the realization date. However, the taxpayer must file a financial report for the year of departure that includes all assets owned and the unrealized gain as of the date of departure.

If the value of the assets subject to exit tax as of the date of departure exceeds NIS 3 million, the assets owned will be allocated to several categories, each having its own rule:

- The first category is readily marketable securities. Assets in this category will be treated as if sold on the departure date and will be taxed and reported accordingly.
- The second category is real estate located outside of Israel. Assets in this category may be treated in one of two ways, at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, reporting obligations will be imposed to ensure proper reporting of the gain when due. In addition, if the tax is estimated to exceed NIS 1.5 million (approximately €420,000 as of November 30, 2021), an interest in the property may be required to be registered in favor of an Israeli nominee.
- The third category is other assets. Assets in this category may be treated in one of two ways at the election of the taxpayer. The first calls for the immediate payment of exit tax and the second allows for postponed payment. Should the individual choose to postpone the payment, title to the assets may be required to be held by an Israeli nominee.

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The Reform also includes additional provisions to prevent tax avoidance. For example, the exit tax may be imposed on dividend income distributed by a foreign company to an individual after that individual's departure. The tax would continue to be imposed until the postponed exit tax is fully paid. Another recommendation is to impose taxes on assets that are sold during a specified period commencing from the day the individual ceases to be an Israeli resident. That period under consideration is four years. The tax would be calculated as though the individual remained an Israeli tax resident.

CONTROLLED FOREIGN CORPORATION ("C.F.C.")

Under current law, C.F.C. rules provide that passive income of a foreign corporation controlled by Israeli residents result in a deemed dividend distributed to the Israeli shareholders in certain circumstances. The Reform will expand the definition of passive income to include income derived from interest, insurance, or royalties received from related parties in specified circumstances. In addition, the Reform proposes to increase the tax base by reducing the passive income threshold to one third of the total income or profits of the foreign company from the current threshold, which is of one third of total income or profits.

The reform would apply the C.F.C. rules on a broader basis for a corporation resident in a country on the black and grey lists of the E.U. (except where the country has an income tax treaty in effect with Israel) or a resident of a country that does not have an agreement with Israel that allows the exchange of information. Under the Reform, the C.F.C. rules would apply once Israeli share ownership reaches 30%, rather than 50% under current law. In addition, the C.F.C. rules would be applied to all passive income of a C.F.C., no matter the percentage which passive income bears to total income or profits.

Also, as part of the Reform, the holdings of new residents and returning residents will be considered holdings of Israeli residents that are taken into account when determining whether a foreign corporation is a C.F.C. Under current law, those holdings are not considered to be owned by Israeli residents for when determining whether a foreign company is a C.F.C. This provision would apply only with respect to assets purchased after the arrival in Israel.

FOREIGN TAX CREDIT

The Reform proposes reducing the current number of foreign tax credit baskets to five. They would be baskets for

- passive income,
- active income,
- capital gains,
- C.F.C.'s, and
- professional foreign corporations ("P.F.C.'s").

In addition, the rules under which credits are provided would be tightened for taxes paid to countries included in the black or grey lists of the E.U. Also under

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consideration is the elimination of the five-year carryforward for unused foreign tax credits that exists under current law, except is specified circumstances.

TREATMENT OF L.L.C.'S

The I.T.A.'s current approach to U.S. L.L.C.'s treats an Israeli member of a U.S. L.L.C. as the owner of the LLC's taxable income only for the purpose of claiming foreign tax credits in Israel for the U.S. taxes paid at the member level. The I.T.A.'s approach explicitly states that an L.L.C. will not be regarded as a pass-through entity for all tax purposes. Consequently, the losses of an L.L.C. cannot be claimed by an Israeli resident as an offset to taxable income.

The Reform proposes to revise the I.T.A.'s approach so that losses derived by an Israeli resident from an L.L.C. formed under U.S. tax law will be available to offset income of that Israeli resident derived from U.S. sources and U.S. situs assets, provided the losses are available in the U.S. to reduce U.S. taxable income. This treatment will be elective and once elected will be irrevocable.

TAXATION OF EXERCISE OF OPTIONS AND WORK INCOME THAT ARE PARTIALLY VESTED WHILE THE INDIVIDUAL IS A FOREIGN TAX RESIDENT

According to the I.T.A.'s approach, an employee's income is calculated on a cash basis so that on the date the employee receives the income, the tax treatment is determined according to the employee's residence on that date. This rule applies also with respect to options granted or vested while the employee is a foreign tax resident. In order to encourage overseas Israelis to return to Israel, the I.T.A. is considering the adoption of a rule under which the employee will be exempt from tax in Israel in respect of the portion that was vested abroad, even if the income was received after the return of the employee to Israel.

BASIS STEP-UP FOR INHERITED PROPERTY

As of today, the I.T.A. allows a step-up in the basis of foreign assets received by an Israeli tax resident as a gift or inheritance made by a foreign tax resident. The I.T.A. is considering modifying the step-up rule. While no decision has yet been taken, several options are on the table. The first is to abolish the existing mechanism regarding foreign assets entering the Israeli tax net. Under this approach the pre-transfer appreciation in an asset received from a nonresident would be taxed in Israel at the time of sale by an Israeli donee or legatee according to the original cost basis. The second is a mechanism to tax overseas legatees when they receive a bequest from an Israeli decedent. This may be analogized to an inheritance or estate tax.

REPORTING OBLIGATIONS

The I.T.A. is considering the adoption of a mandatory information report that would be filed annually by an Israeli shareholder who holds, directly or indirectly, more

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than 50% of the controlling shares of a foreign corporation. The profit and loss statement of the foreign corporation and its P&L would be attached to the report. Also to be attached would be the names and other information of directors, management members, and shareholders. Finally, the I.T.A. is considering the imposition of a reporting obligation on resident individuals who receive a payment or a gift from abroad in an amount above NIS 500,000 (approximately €140,000 as November 30, 2021).

CONCLUSION

"Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad."

Whether it is B.E.P.S., Pandora Papers, E.U. blacklists, or the Biden Administration tax proposals, governments and tax authorities are examining new ways to fund operating costs of government and to raise the level of examination for the wealthy, especially those with one foot at home and another abroad. The Reform under consideration by the I.T.A. is in line with the current trend.

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