ISRAELI START-UP EXPANSION TO THE U.S.: WHO SHOULD BE ON TOP?

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INTRODUCTION

Congratulations. Your Israeli start-up is doing well enough for you to consider expanding operations to the U.S. market. Now what? The list of things to think of is endless, and tax should be at the top. Among other matters, you will need to consider

- the legal entity to use when expanding to the U.S.;
- whether the workforce should relocate Israeli employees to the U.S., hire locally in the U.S., or have employees work from Israel post-COVID19;
- investigation of appropriate transfer pricing policies for transactions between the U.S. entity and the Israeli entity, acceptable to tax authorities in each country, especially in regard to payments for the use of intellectual property; and
- identifying the group entity that should own the I.P.

This article considers these and other questions and presents views from both the U.S. and Israel. Like many other things in life, one answer may be preferable in certain circumstances but not others and balancing the conflicting forces is required.

EARLY-STAGE V. ADVANCED

Two early-stage considerations will impact planning latitude:

- Has intellectual property ("I.P.") been developed?
- Has money been raised from investors?

It becomes exceedingly more difficult to revise a structure as operations of the start-up becomes more advanced over time. If Israeli entrepreneurs don't think globally from the very beginning, moving ownership of the I.P. from the Israeli company to a U.S. subsidiary may be very expensive in terms of gain recognition in Israel. And while eventually it may be a necessity, the cost increases as time passes.

If the Israeli company will have very early-stage investors, their consent will be needed for any restructuring. Unless they are U.S. persons – which is not likely in this scenario because U.S. persons would have asked for a U.S. entity at the time of investment – they may resist.

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ESTATE TAX

One of the benefits for non-U.S. investors of a structure involving an Israeli parent and a U.S. subsidiary is the avoidance of exposure to U.S. estate tax at the conclusion of life of a non-U.S. shareholder. With planning, U.S. estate tax exposure for a non-U.S. investor can be addressed in several ways, including by the imposition of a personal holding company or obtaining term life insurance. Shares may also be gifted during life without the imposition of gift tax by a non-domiciled individual as they are considered to be items of intangible property. Consequently, limiting estate tax exposure for a non-U.S. investor by demanding an Israeli parent company should not be a driver in the decision-making process.

Removing the U.S. estate tax exposure from the equation, having a U.S. parent company at the top of the structure should be considered from the get-go. Of course, Israel is closer to Europe and there are other incentives to consider, which are discussed below. However, if the market and target investors are in North America, it may be prudent to consider starting out in the U.S. in a structure that will be favored by future investors and where corporate laws are developed and generally friendly. After all, the goal is to maximize the size of a liquidity event, not simply to limit potential U.S. estate tax exposure that results from an untimely death.

Having focused on pleasing potential U.S. investors, it is important to remember that, if I.P. developed in Israel is held by a U.S. parent, the Israeli Tax Authorities ("I.T.A.") may take the position that the economic ownership of the I.P. is in Israel if no sufficient substance exists in the U.S. parent because of an absence of substantial U.S. operations, employees, and facilities.

I.P.

Ownership of I.P. justifies special consideration as it is never easy to move I.P. out of corporate form without triggering gain recognition.

U.S. buyers are likely to want the I.P. to be owned in the U.S. in order to benefit from incentive legislation that can drive the tax rate down or to avoid immediate U.S. taxation of income generated by the I.P. under certain anti-deferral regimes. If I.P. is created in an Israeli entity and eventually the company is acquired by a U.S. buyer, the buyer is not likely to retain the I.P. in Israel and may factor the tax cost of moving the I.P. to a U.S. affiliate when structuring its best offer.

Unless the buyer structures the transaction as an asset deal, post-acquisition extraction of the I.P. would trigger significant amounts of Israeli tax, even if the acquired Israeli start up maintains its operations under the new business model led by the buyer. The tax treatment of a transfer of I.P. from a newly acquired Israeli subsidiary has been a hot topic in the last few years and the I.T.A. argues that such transactions constitute taxable business restructuring pursuant to applicable transfer pricing rules, contending that the company's acquisition price is the proper benchmark for the value of the I.P.

For all the foregoing reasons, I.P. ownership is a consideration to think of in the early stages. At that time, an Israeli start-up may structure its ownership to have a U.S. parent company and an Israeli subsidiary acting as an R&D contractor in developing I.P. for the U.S. parent.

However, locating the I.P. in the U.S. contains its own risks regarding Israeli tax:

- One is that young entrepreneurs may not have sufficient finances in the early stages to maintain real operations in the U.S.
- A second is that, if the U.S. parent is simply financing I.P. development in Israel, the I.T.A. may claim that the "economic" ownership of the I.P. is in Israel or that substantial income must be allocated to the Israeli subsidiary.
- A third is that the I.T.A. may argue that the Israeli subsidiary transferred I.P. having substantial value to the U.S. parent. If any of these assertions are raised, the Israeli company and its owners may find that they face a more complicated situation than would have existed if the I.P. were located in the Israeli subsidiary from day one.

Punting on the issue is always possible for an early-stage company. It certainly is of no harm if the I.P. fails. It is only when the I.P. appears to be attractive that the early shareholders will have remorse because the opportunity of moving the I.P. with little cost has been missed.

LEGAL ENTITY AND P.E.

If the Israeli start-up is simply testing the waters in the U.S., it may consider hiring an independent contractor to distribute a product or provide other services in the U.S. The issue here is to avoid having that person be considered a dependent agent whose presence in the U.S. could create a permanent establishment ("P.E.") in the U.S. A P.E. can expose a portion of the company's income to U.S. taxation.

While a detailed analysis of the possible existence of U.S. trade or business and a U.S. P.E. is beyond the scope of this article, one benefit that is derived when a treaty applies is that a higher threshold of activity must exist in the U.S. in order for the U.S. to impose income tax. If a treaty applies, the occasional conduct of activity in the U.S. by employees or agents of an Israeli start-up would likely not be enough to give rise to U.S. tax exposure on income generated in the U.S. Without a treaty, any activity conducted in the U.S. may be sufficient for the I.R.S. to characterize income that arises in the U.S. as effectively connected taxable income. Such income is subject to corporate income tax on the Federal and State levels and Federal branch profits tax.

In broad terms, a P.E. exists when the foreign company has a fixed place of business through which it is engaged in activity in the U.S. for an indefinite or substantial period. A company may have a P.E. directly by sending its employees to the U.S. and operating through a branch, or indirectly, through dependent agents that have the power to conclude binding contracts on behalf of an Israeli company. Note that a dependent agent empowered to negotiate the terms of a contract likely will be a P.E. even though the contract is not binding until approved by the head office in Israel. In comparison, the activities of independent agents generally don't give rise to a P.E., provided the agent is independent both economically and legally. An agent is not truly independent if it has only one customer and is integrated in the sales and marketing activity of that sole customer. Nor is an agent independent when its sole customer has control over what the agent does and how it is done, especially when the agent bears no economic risks. In those circumstances, the activities and place of business of the agent may be attributed to the company and could create a P.E.

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Forming a U.S. limited liability company ("L.L.C.") that is wholly owned by the Israeli company and operating through it in the U.S. will result in the creation of a U.S. branch of the Israeli company, which results in the existence of a P.E. For U.S. tax purposes, a single member L.L.C. is not regarded to be separate from its sole owner unless an election is made for U.S. income tax purposes to treat the L.L.C. as a corporation. Where that election is made, the L.L.C. is treated as if it were separate from its owner, the Israeli company.

If a corporate subsidiary is formed in the U.S. by an Israeli corporation, the subsidiary does not itself create a P.E. for the Israeli company, provided it does not operate as the Israeli company's agent in the U.S.

Transactions between the Israeli company and its U.S. subsidiary are subject to arm's length transfer pricing rules in both Israel and the U.S., and the application of those rules in any given circumstance may provide different results in each country. In principle, only the income of the U.S. entity would be subject to U.S. taxation, and none of the Israeli company's income would be attributed to the U.S. subsidiary and be taxed in the U.S. However, the views of tax authorities in the U.S. and Israel may not be consistent when determining the scope of the U.S. company's U.S. source income.

COVID19 presented an interesting situation where many workers worked remotely. While, at first, no one thought remote working could be a long-term situation, now it is clearly acceptable, and many companies have adopted hybrid work rules. Full remote, or even hybrid U.S.-Israel remote work may not be easy to sustain in the long term. Nonetheless, those companies that have adopted such working arrangements must consider whether they create a P.E. when the arrangement has lasted for two or more years.

If the start-up intends to hire local employees or send Israeli employees to the U.S., it may be prudent to create a U.S. subsidiary sooner rather than later. putting aside the tax issues and P.E. issues, it is much easier for a U.S. company to maintain a payroll for employees and executives working in the U.S.

FOREIGN OWNERSHIP COMPLIANCE

U.S. ownership of foreign corporations may present significant reporting obligations, and under certain circumstances, may impose unfavorable tax rules. One such rule is the P.F.I.C. regime. Very broadly described, a passive foreign investment company (or 'P.F.I.C.") is a foreign corporation which meets one of two alternative tests:

- The first is an income test, under which 75% or more of the company's gross income is categorized as passive income.
- The second is an asset test, under which 50% or more of the company's assets are passive assets (including cash in excess of 90-day working capital and stock in underlying portfolio companies).

In years during which an Israeli company raises capital, and the cash is the most significant asset reported on a balance sheet, the company may be classified as a P.F.I.C. unless an off-balance sheet asset is identified, and a proper valuation is obtained to support a non-P.F.I.C. position. Even then, the cash must not be invested it short-term liquid assets producing passive income that is greater than the allowed threshold.

An Israeli company's P.F.I.C. analysis must be conducted annually and if an Israeli company is classified as a P.F.I.C. for any year, it retains its classification under a rule known as "once a P.F.I.C. always a P.F.I.C." P.F.I.C. status is problematic. Any ordinary dividend received from a P.F.I.C.by a U.S. individual is taxed as ordinary income that does not qualify for the lower, long-term capital gains rate which applies to dividend from a qualified foreign corporation. The tax treatment in the U.S. is worse if an "excess distribution" is made. An excess distribution is a distribution that exceeds 125% of the average distributions made by the foreign company in the three years immediately prior to the tested distribution. In computing the current year's tax on an excess distribution, the distribution is allocated to each day in the holding period of the shares. The tax on the deemed increase in income in each such prior year is computed at the highest rate for that year and is deemed paid late. The deemed late payment of tax is subject to an interest charge. Similar treatment is given to capital gains from the sale of P.F.I.C. shares.

A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.*

Other rules may apply and result in current taxation of the earnings of the foreign corporation irrespective of distributions if the Israeli company is considered to be a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes. And even if the company is not a C.F.C., certain reporting on Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations,* is required. The failure to file Form 5471 or the filing of an incomplete form may trigger significant penalties over time. Note that the I.R.S. view of an incomplete form may not be the same as the view of the U.S. shareholder or its tax return preparer.

"A U.S. investor in a P.F.I.C. is subject to annual reporting on Form 8621 . . ."

Other heightened reporting also applies as a result of a need to report specified foreign assets (including shares in a foreign corporation) and possibly to file an F.B.A.R. form with FinCEN, a branch of the I.R.S. that enforces the Bank Secrecy Act. The F.B.A.R. reports ownership, financial interests, and signatory authority over foreign financial accounts owned by a U.S. company and its overseas subsidiaries.

Q.S.B.S.

Another consideration for having the parent company in the U.S. is the benefit provided in Code §1202. This Code section applies only to shares in a C corporation (*i.e.*, not an L.L.C. electing to be taxed as a corporation). When applicable and all requirements are met, U.S. taxpayers selling shares are eligible to exclude from their long-term capital gain the *higher* of $10,000,000 or 10 times the adjusted basis in the shares. This is a significant benefit that is attractive to investors and managers of U.S. investment funds. They are keenly interested in investing in U.S. corporations and not foreign corporations, and they may ask that the Israeli company invert with its subsidiary.

Acknowledging such situation, the I.T.A. developed a fast track for inverting using the exemptions available under the tax-free reorganization law.

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ENCOUREGEMENT LAWS AND THE I.I.A.

One of the most attractive reasons to base the operation in Israel is the availability of benefits granted under the encouragement of capital law. Companies that qualify under the terms and conditions of such laws and that are based in central Israel will be eligible to pay a 16% corporate tax rate (compared to the standard corporate tax of 23%) and have dividend payments taxed at 20% (compared to 20%-30%). Eligible companies that are based outside of Israel's dense urban center are eligible for a corporate tax rate of only 7.5%, although the rate may be increased considering the forthcoming O.E.C.D 's Global Minimum Tax. Those reduced tax rates may be significant and should keep investors happy, except if those investors are U.S. citizens who then may be unhappy to discover that the Israeli rate does not qualify for the high-tax exception under anti-deferral rules applicable to U.S. persons owning 10% or more of the shares of a controlled foreign corporation.

Additionally, the Israel Innovation Authority ("I.I.A.") offers unique tools for entrepreneurs and start-ups to support the early development stages of technological initiatives. These tools assist in developing innovative technological concepts at the pre-seed or initial R&D stages, transform ideas into reality and reach significant fundable milestones. However, receiving grants from the I.I.A. comes with an obligation to pay royalties to the I.I.A. and penalties are imposed if the I.P. developed eventually is sold to a non-Israeli entity.

TRANSFER PRICING

Regardless of which company is the parent and which is the subsidiary, all transactions between a U.S. company and its Israeli affiliate (including charges for the use of I.P., interest accruing on loans, and inventory purchases) must be carried out in a manner that is consistent with arm's length principles. The taxable income of each entity must be clearly reflected and supported by a transfer pricing study that is based on methodologies allowed under U.S. Treasury Regulations and the Israeli transfer pricing regulations. If the transfer pricing is set at a price that is not deemed to be arm's length -- so that the U.S. company's profits are understated – the I.R.S. and the I.T.A. are authorized to adjust the price and impose penalties on the adjustment. Penalties may be avoided if a proper transfer pricing report is prepared on a timely basis. The report must explain the price determined and the methodology used and the reasons why the price was determined under the best method available under the regulations. In addition, the report must be prepared on a timely basis, which means prior to the date of the filing of the tax return for the year.

The arm's length transfer pricing rules in the U.S. may differ in technical ways from the O.E.C.D. Transfer Pricing Guidelines which the Israeli transfer pricing regulations draw upon. Separate reports must be prepared under both sets of rules, one for the U.S. and the other for Israel. In principle, the transfer pricing result should be the same under both. However, that is not always the case.

SUMMARY

The answer to the question "so what do you advise me to do" is never an easy answer. Young entrepreneurs are required to act as "fortune tellers" in the process of establishing their new business. The questions that should be asked at the outset include all of the following:

- What markets should we aim for?
- Will Israelis or Americans comprise the bigger share of our investor group?
- Will we need government support at the early stages?
- Will our exit strategy focus on the sale of assets, a private sale of shares, or an I.P.O?
- Where do we intend to live if the business succeeds?
- Who are the employees we want to hire and where do they live?

Those and many other questions may be very difficult to answer at the outset and are somewhat of a guess at the early stage; but they are important and may impact the taxation of their success. One bit of nontechnical advice that should be kept in mind – if difficulty is encountered in answering the foregoing questions, it may be time to purchase a new crystal ball.

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