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New Israeli Tax Guidance on On-line Activity of Foreign Companies

General

The Israeli Tax Authority ("ITA") recently published a new draft circular (the equivalent of a Technical Advice Memorandum in the US) on the taxation of the activity of foreign companies in Israel through the internet (the "**Draft Circular**").

The purpose of the Draft Circular is to determine the situations in which the income of foreign companies from the provision of services, primarily via the internet, shall be deemed to accrue through a permanent establishment in Israel ("**PE**"). Consequently, the Draft Circular attempts to determine the profit allocation and thus the Israeli taxable income of the PE. The Draft Circular sets low and rather amorphous thresholds for the creation of a PE in Israel.

In addition, the Draft Circular sets forth those situations in which foreign companies providing services to Israeli clients via the internet should register in Israel for VAT purposes and pay Israeli VAT.

The publication of the Draft Circular for public comments is a very unusual step by the ITA.

The Draft Circular incorporates some ideas contained in the interim reports of the OECD and the G-20 project on base erosion and profit shifting ("**BEPS**").

There is no guarantee when or whether the Draft Circular will become a formal circular, and even if it will be concluded it does not bind the courts. However, the concepts in the Draft Circular reflect the developing approach of the ITA towards the taxation of internet activities of foreign companies in Israel. We note also that the ITA has committed to the Supreme Court of Israel to issue a circular on these issues, and that often the views expressed in such internal publications

become operational policy guidelines for tax inspectors.

In our view, the Draft Circular emphasizes the need for foreign corporations operating in Israel through on-line activities, to analyze their operations in light of the Draft Circular, and where needed to construct strategies and procedures to mitigate their PE exposure.

We have set forth below a summary of the Draft Circular.

A. Income Tax Aspects

1. The Draft Circular attempts to apply the principles of the OECD Model Tax Convention on Income and on Capital (the "**OECD Model**"), in the digital economy.

Under the OECD Model, a PE can arise in two scenarios: (a) the business activity is conducted through a fixed place of business available for the foreign venture ("**Fixed Place of Business**"); or (b) the business activity is conducted through a dependent agent who has the authority to conclude contracts ("**Dependent Agent**").

1.1. PE which arises as a result of Fixed Place of Business

In the context of a digital economy, the location of the servers was often considered to be a key factor. According to the Draft Circular, the absence of servers in Israel does not preclude the possibility that other economic activities carried out via physical facilities in Israel could nonetheless, in the context of the digital economy, be sufficiently significant to constitute a PE in Israel. In parallel to the low significance attributed by the Draft Circular to the servers, greater significance is given to the location where other economic activity is performed.

Although under the OECD Model the use of facilities solely for the purposes of storage, purchase of goods, collecting information, provision of advertising services, or conducting scientific research for the foreign entity does not constitute a PE (the "**PE Exceptions**"), the Draft Circular states that such activities would constitute a PE if such activity is not solely auxiliary activity.

The draft states that when **all or some** of the following conditions exist, the internet activity should not necessarily be seen as PE Exceptions, but rather as **an activity that might constitute a PE in Israel**:

- If, in addition to the facility in Israel, the foreign corporation operates a website adapted for Israeli customers (language, publications, style, currency etc.);
- If the website connects Israeli costumers with Israeli suppliers/service providers;
- If the website is highly popular among Israeli users;
- If the profitability of the website increases with the number of users and the scope of their activity;
- If representatives of the foreign corporation in Israel, assisted by the Israeli facility, are involved in customer recruitment or data collection.
- Customer Relations Management – if an ongoing relationship exists between the representatives of the foreign corporation, assisted by the Israeli facility, and Israeli customers (e.g., organizing customer conferences, creating opportunities to present new products, development of the service provided to the customer, providing feedback to the foreign corporation with respect to its performance in the local market, etc.);
- If there are significant marketing and support services provided in Israel through a

- representative of the foreign corporation;
- If the foreign corporation bears business risks in Israel.

The facilities of a related Israeli company, which were made available to the foreign corporation, and which served the foreign corporation in generating its own income (as opposed to that of the Israeli company) may be considered to be facilities of the foreign company.

In addition, an employee who is formally employed by an Israeli company, but substantially reports to personnel of the foreign company, may be considered an employee of the foreign company or as its agent and therefore may constitute a PE in Israel. The extent of the foreign company's involvement in the process of recruiting employees in Israel and in setting the terms of employment may also indicate that the foreign corporation is the effective employer.

The Draft Circular further states that in accordance with the BEPS project, a wider approach, which would change the basic concept of PE, may be adopted. According to this approach a "Significant Digital Presence" focusing on customer relations might constitute a PE, while physical presence would be considered of less importance.

1.2. PE Constituted by a Dependent Agent

According to the OECD Model, a Dependent Agent who has the authority to conclude contracts constitutes a PE (even if this agent is not a formal party to the contract, but conducts a binding negotiation). Moreover, even if the contract is signed by the foreign corporation, this does not eliminate the agent's **"authority to conclude contracts"**. Since the operation of multinationals in Israel is often conducted with the assistance of Israeli or Israel-related companies or other Israeli sub-contractors (an **"Israeli Agent"**), these agents may constitute a Dependent Agent. The following indications may be used to determine whether the Israeli Agent constitutes a PE:

- The extent of the negotiation authority granted to the agent;
- Whether the agent has authority to commit to a certain price and commercial conditions (whether within a pre-defined framework dictated by the foreign company or at the discretion of the agent);
- The agent's involvement in adapting the contract to the requirements and needs of the customer is significant;
- The agent's authority to grant benefits;
- The agent is a party to the contract between the foreign venture and the customer, etc.

In the case of a standard contract, with no flexibility to conduct real negotiation, the agent's status would be determined on the basis of the characteristics of the contract and the agent's direct contribution to its conclusion.

1.3. Allocation of Profits to the PE - Once a determination has been made that a foreign corporation has a PE in Israel, the applicable portion of the foreign corporation's profits should be allocated to the Israeli PE. Under the OECD guidelines, the income allocation should be made on an arms' length basis after an analysis of the functions (and especially significant personnel functions), significant risks and economic assets which exist with the PE. The Draft Circular contains some specific details on the Transfer Pricing methods that exceed the scope of this newsletter.

2. In the case of a foreign corporation that is a resident of a state which does not have a tax treaty with Israel, the attribution of income to Israel would be determined solely according to the domestic tax law and there is no requirement for a PE. The characteristics noted above may serve as indicia for conducting business activity in Israel.

3. A PE constituted in Israel would have to file a tax return according to the applicable allocation of profits. This duty of reporting is separate from the reporting obligations of the Israeli subsidiary, including with regard to loss setoffs and the allocation of profits.

In order to examine the existence of a PE and the allocation of profits, the ITA may ask for information related to the Israeli activity from the foreign corporation and any related Israeli entities.

B. VAT Aspects

1. A foreign corporation that has a 'real business' activity in Israel and the transactions that constitute this activity are subject to VAT should register as a "Dealer" in Israel.

2. In the event that there is direct and close linkage between the services provided, in significant volumes, by the foreign company via the internet to their Israeli customers in Israel, and the circumstances of such services are related to Israel, it can be argued that there is in fact business activity in Israel for VAT purposes.

Such linkage could be based on the following parameters:

2.1. The Service is provided to Israeli customers who wish to receive services in connection with Israeli users in Israel (e.g. intermediary services or advertising among Israeli users).

2.2. The service provided to Israeli customers of the foreign company is directed to Israeli users.

2.3. The service is practically carried out in Israel since the service is performed by presenting content to the Israeli users' computers and usually through Israeli websites.

2.4. In some cases, the marketing activities and customer recruitments of the Israeli customers, as well as the support for these customers is conducted in Israel by a related Israeli company.

2.5. The services provided by the foreign company are consumed in Israel.

3. The following are examples of cases in which a foreign company providing advertising services, mediation, etc., via the internet should be registered as a "Dealer" in Israel:

3.1. A foreign company operating a search engine will have to register with respect to income from advertising services directed to Israeli consumers or users.

3.2. A foreign company operating a website for reservation of hotel accommodations in Israel will have to register with respect to income from reservations of hotels in Israel by Israelis.

4. In addition, a foreign corporation that provides services via the internet to Israeli customers and has a PE in Israel, is presumed to be running a business in Israel, and therefore must register as a "Dealer" with respect to its Israeli clients.

5. A foreign corporation that should be registered as a "Dealer" is not considered a foreign resident, and therefore a sale of intangible assets or provision of services to such entity, in connection to its VAT-liable transactions in Israel, will be subject to VAT.

Summary

The concepts and parameters laid out in the Draft Circular reflect the developing approach of the ITA towards the taxation of internet activities of foreign companies in Israel. The Draft Circular adopts an expansive interpretation as to Israel's right to impose tax on foreign companies operating in Israel. While the draft has no formal standing, and even if it will be concluded it does not bind the courts, the views expressed in internal publications like this often become operational policy guidelines for tax inspectors.

In our view, the Draft Circular emphasizes the need for foreign corporations that operate in Israel via the internet to analyze their operations in light of the Draft Circular, and where needed to develop strategies and procedures to build a mitigation plan against PE exposure.

This newsletter is provided for informational purposes only and does not constitute tax advice or a tax opinion; therefore, it should not be implemented without consulting with the tax partners of our firm.

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