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Letter

The “Israeli Resident” test for a company – guidelines for “Management and Control” according to the matter of Yanko Weisz

The residency of a company has a significant impact on the company itself, as well as on its shareholders. Under Israeli tax law, a company will be treated as an “Israeli Resident” if (i) it is incorporated under the laws of Israel, or (ii) Israel is the place of its management and control.

An Israeli resident company is subject to tax on its worldwide income, will be required to submit annual tax returns, and will also be required to withhold tax on payments to non-Israeli residents.

The “management and control” test has become more relevant recently as more Israeli residents establish foreign companies and appoint foreign board of directors while retaining effective control of the actual management activities of the company. Similarly, there are cases of foreign companies with local Israeli employees who are granted broad control over the decision making process of the foreign entity. In both of these cases, the question arises as to whether the management and control should be treated as occurring in Israel, thereby rendering the company an Israeli resident.

Recently, in *Yanko Weisz Holdings 1996 Ltd. vs. Assessing Officer Holon*, TC 1090/06 (“**Yanko Weisz**”), the District Court revisited the question of a company’s “Management and Control” and clarified the criteria that had been previously set out in *Itzhak Niago Z”L et al vs. Assessing Officer Kfar Sava*, TC 1029/00 (“**Niago**”) [Please see our Memorandum regarding Management and Control following the Niago Case (in Hebrew)]. In Yanko Weisz, the District Court identified specific factors that indicate where the strategic management of a company is conducted, and therefore whether the "Management and Control" of the company was performed in Israel. The court concluded that a determination of the location of the “Management and Control” of a company incorporated outside Israel requires an analysis of the legal and factual circumstances. If Israeli residents are involved in a company’s management, in order to successfully claim that

the company's management and control are conducted outside of Israel, the company will need to demonstrate that the strategic decisions as well as the ongoing management decisions of the company have taken place outside of Israel.

Assessment of the exposure that a company that is incorporated outside of Israel and that has some form of an Israeli connection may be treated as an Israeli resident under the "Management and Control" test requires an analysis of the relevant facts under the principles established in *Niago, Yanko Weisz*, as well as in circular no. 4/2002 that was published by the Israeli Tax Authority in 2002 (the "**Circular**").

This memorandum provides a brief discussion of the criteria for determining the residency of a company that was incorporated outside of Israel, according to the guidelines of the "Management and Control" test as were examined in *Yanko Weisz*.

A. Summary of the Facts

1. The Yanko Weisz Company (the "Company") was incorporated in Israel in 1996. All of the Company's shareholders were Israeli resident individuals. Until the year 1998 the Company held its essential assets in Israel. It is unclear whether the Company also held assets outside of Israel as of that time.
2. According to the Company, around 1998 it made a strategic decision to place its investments and activities in Belgium, and to transfer to Belgium its major activity as well as its management and control.
3. Towards 1999, the Company was registered as a Luxembourgian company, and in 1999 it was also registered as a Belgian company.
4. In July 2000, the Company sold its holdings in an Israeli resident company.
5. The company did not report any capital gain on the sale of its Israeli subsidiary's shares.
6. The Company took the following major actions demonstrating that it maintained a base of operations in Belgium:
   a. During the years 2002-2005 the Company made investments and further acquisitions of real estate in Belgium.
   b. The Company engaged local directors to manage the ongoing maintenance and leasing of those properties, and the Company paid each of the Belgian directors Euro 3,000 per annum.
   c. The Israeli shareholders of the Company continued to be involved in some of the decision making process of the Company.
   d. Although the Israeli managers of the Company gathered in Belgium a few times, the Company failed to prove that its Board meetings were regularly held in Belgium.
   e. The managers of the Company, as well as its advisors, such as architects, engineers, legal and financial advisors and accountants, operated from Belgium.
   f. The Belgian directors had signatory authority over the Company. However, the Israeli shareholders had signatory authority over the Company's bank account.
   g. The apartments that were rented or sold by the Company were located in Belgium. The Company's tenants, the buyers of the Company's apartments, the Company's customers and suppliers were all Belgian residents.

h. The bank account of the Company was managed in a Belgium bank.
i. The Company's books were managed in Belgium and the Company filed its annual tax reports in Belgium.

B. The ITA's Position

1. The Israeli Tax Authority's (the **"ITA"**) took the position that the Company was actively managed in Israel by its Israeli managers from the time the Company was incorporated. Notwithstanding, the Company's major assets were located in Israel during the relevant tax year (2000), while the actions as were executed by the suppliers that the Company had haired in Belgium did not constitute "Management and Control" in Belgium.
2. Furthermore, at the same time that the case was proceeding before the Distinct Court, the ITA and the Belgian tax authorities engaged in a "mutual agreement procedure." The outcome of the procedure was that the Belgian tax authorities conceded to the ITA's position and agreed that the decisions relating to the Company's activity in Belgium were actually made in Israel by a few of the Company's Israeli shareholders, and were later put into effect in Belgium. As a result, the ITA and the Belgian tax authority agreed to treat the Company as an Israeli resident. It appears that the tax authorities were applying Article 4(3) of the Tax Treaty between Israel and Belgium, which provides that when a company is considered as resident of both countries, it should be deemed to be a resident of the state "in which its place of effective management is situated".

C. The Court's Decision

Upon examining the evidence, the Company's ongoing activity, as well as the activity of the Israeli shareholders and the Belgium managers, the court concluded that the Israeli shareholders of the Company effectively controlled and managed the Company's business and therefore the Company should be considered as an Israeli resident during the tax year 2000.
The court held that the shareholder's hiring and/or otherwise engaging the services of Belgian professionals to assist with the purchase and management of the real estate assets, their rental and the financial aspects was not sufficient and did not create "Management and Control" in Belgium.

D. Principal Factors for Determining "Management and Control"

1. One of the principal factors in determining whether management and control is in Israel is where the policy is set by and whether the strategic decisions of a company are made by Israeli shareholders in Israel. In *Yanko Weisz*, the court noted that although unlimited management authority was given to the Belgian managers in 2000, the Israeli shareholders had, in fact, executed the decision regarding the exercise of the option of selling the subsidiary's shares.
2. Recent technology developments and the proliferation of management services in countries which seek to encourage inbound investments, make it harder to prove the

existence of essential management of a company outside of Israel. Nevertheless, courts may still find that an Israeli resident manages the company's business outside of Israel, as long as ongoing, permanent management procedures actually take place there.

3. An Israeli resident will in fact have an increased burden of proof when claiming that he did not manage a company from Israel, and he will have to refute the argument that the purpose of his trips abroad were to obfuscate his actual management of the company from Israel.
4. The determination that a company is an Israeli resident is based on multiple facts and circumstances and is not determined by any single factor.
5. Constant, regular and ongoing management outside of Israel is required in order to support the conclusion that a company is not managed from Israel, even if a few of its managers are Israeli residents.
6. In situations where there is a management team in the foreign county that coordinates management with an Israeli manager, the exposure that such company would be treated as managed and controlled in Israel is mitigated to the extent the Israeli managers' trips abroad extend for more significant periods and the decision making process actually takes place while they are abroad and not prior to their trips. In contrast to shorter trips, longer stays abroad further enable the Israeli manager to actually manage the business of the Company.
7. A company in which some of the management activity is conducted in Israel may still successfully take the position that management and control is outside Israel if the substantive, strategic decisions are made by a board of directors outside of Israel, and such decisions are implemented by a management team outside of Israel.
8. The appointment of a foreign manger who lacks real, substantial management authority over the ongoing management of a company, its strategic decisions or its financial commitments will not support a management platform outside of Israel. In other words, engaging the services of a management company at a low price and refraining from granting such management company actual management authority over the company will generally not indicate that the company's "Management and Control" is conducted outside of Israel.
9. In addition, the company should carefully maintain and keep corporate records that substantiate that the company's management was conducted outside of Israel. For example, such records would include minutes of meetings at which such decisions were made, indicating where the meeting was held, who was present and what topics were discussed and decided.
10. The determination of the residency of a company, including the place of its control and management, is made on an annual basis.

To summarize, the "Management and Control" test for a company which was incorporated outside of Israel will be determined according to all the facts and circumstances, taking into account the principles laid out in *Niago, Yanko Weisz*, and the Circular. In a case where Israeli residents are involved as major shareholders or otherwise involved in some decision making capacity, the company may face a higher burden to prove that its management and control actually occurred outside of Israel. The company will need to prove that outside of Israel there

existed an ongoing, steady management procedure with respect to the company's strategic, as well as day-to-day decisions.

The purpose of this memorandum is to alert you to developments regarding the Management and Control of a company, and the classification of its residency for tax purposes in Israel.

The "Management and Control" field is dynamic and some of the cases are being appealed to the Supreme Court. This memorandum is provided for information purposes only and does not constitute tax advice or a tax opinion; therefore, it should not be implemented without consulting with the relevant personnel of our firm.

If you have further questions related to this document, please contact the lawyers specified below or directly with your contact person in the office:

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