



## NEW TAX RULING - AN ISRAELI PERMANENT ESTABLISHMENT OF A FOREIGN CORPORATION WITH ONE EMPLOYEE IN ISRAEL

On July 2, 2012, the Israeli Tax Authority ("**ITA**") issued ruling 253/12 (the "**Ruling**"), addressing the issue of when a foreign corporation with only one employee in Israel will be treated as having an Israeli permanent establishment ("**PE**"). While the Ruling reflects the position of the ITA, the Ruling does not have the force of law and courts in Israel are not bound to accept the position of the ITA as presented in the Ruling.

If you have any questions regarding the matters in this legal update, please contact the following attorneys or call your regular Meitar contact.

### **A. Existence of a PE**

1. These days, in the era of global village, many companies have employees and engage service providers in different countries worldwide. The employment of foreign human capital, however, raises tax considerations that need to be examined prior to such employment. The main exposure of such employment is that the employing entity may be treated as having a PE in the country in which such services are performed. If so, the employing entity may be at risk of exposure to taxes on its income in this country.

2. Under Israeli domestic law, the income resulting from all services performed within the State of Israel, whether by an Israeli resident or a foreign resident, is subject to Israeli income tax. However, under the tax treaties to which Israel is a signatory, the earnings of a resident of a treaty country arising from the performance of services within Israel is generally not subject to Israeli income tax as long as this activity does not create an Israeli PE. The determination of what constitutes an Israeli PE is governed by the particular treaty under which benefits are claimed, the OECD Model Treaty, and various court rulings (but not by the Israeli Income Tax Ordinance [New Version], 1961, which lacks a definition of this term). In general, a PE is a fixed office or place of business through which a person engages in industrial or commercial activity. Furthermore, a company may be treated as having a PE in a country in which it has representatives who are dependent agents, and such agents have, and habitually exercise, the authority to conclude contracts in the name of the company or to negotiate contracts in a binding way on behalf of the company.

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### **B. Main Issues in the Ruling**

3. The Ruling addresses whether a foreign corporation is treated as having an Israeli PE due to activity performed by an Israeli employee. The Ruling was issued based on the following facts:

- A foreign corporation that provides financial services abroad employs, on a salaried basis, a portfolio manager who works from her home in Israel.
- The foreign corporation has no Israeli clients and it does not market its services to clients in Israel.
- The employee does not perform marketing or sales services, does not negotiate on behalf of the company, and is not responsible for obtaining new clients; her interaction with clients, if any, is minor.
- The employee's independence is limited. Any decision and initiative is subject to the approval of the senior manager above her and she does not have the power to bind the company with her actions. The company is the responsible party with respect to its clients, not the employee.

4. In the Ruling, the ITA held that the employee performance of services from Israel creates an Israeli PE for the foreign corporation even though her authority is limited. According to the Ruling, the ITA's position appears to be that almost any employee or service provider of a foreign corporation who performs services in Israel should be treated as an Israeli PE of the foreign corporation. This means that a foreign corporation with an Israeli employee would be required to open a tax file with the ITA and the VAT authorities, submit Israeli tax returns and pay Israeli income tax on any income that is attributable to the Israeli PE.

5. The ruling does not address the issue of income is to be attributed to the PE generally. In the specific case addressed in the Ruling, the ITA held that the foreign corporation must open a tax file and that the amount of income that was to be treated as attributable to the Israeli PE was equal to 10% of the total gross salary paid to the employee. However, the Ruling also clarified that the calculation of the profits of the Israeli PE will generally be subject to the determination of the local assessing officer who has responsibility for the region in which the company files its tax returns.

### **C. Consequences from the Ruling**

6. This Ruling reflects a position that is not consistent with previous tax rulings, which had held that a foreign corporation did not have an Israeli PE even if it had an Israeli employee, if the Israeli employee was not authorized to contact, sign, commit or negotiate on behalf of or for the company. However, since the relevant facts, limitations and restrictions of the Ruling are not all publicly available, we cannot determine the rationale for this decision in contrast to previous decisions or other situations from which this Ruling may be distinguishable.

7. Furthermore, the Ruling raises many questions, such as, why the foreign corporation did not request a ruling that the employee's operation in Israel does not create an Israeli PE at all, rather than a ruling that appears to presume the existence of an Israeli PE and only approves the amount of income attributable to the PE. Furthermore, it is not clear whether the premise that the company had an Israeli PE was presumed by the company and its advisers, or presumed by the ITA.

**In light of the ITA's position in this Ruling regarding the existence of an Israeli PE resulting from the presence of an employee in Israel, it is highly recommended that a foreign company should examine the matter carefully prior to employing an individual or engaging a service provider on similar terms in Israel. This analysis should extend both to the determination of whether to engage in services to be performed in Israel as well as to the terms and conditions of any such engagement (including the drafting of the employment/service agreement). Moreover, under certain circumstances, it may be advisable to request a ruling from the ITA.**

**The purpose of this memorandum is to bring updated information to your attention regarding a tax ruling on the subject of the existence of a permanent establishment of a foreign company having an employee in Israel.**

**The memorandum is not a reliance opinion; therefore, it should not be implemented without consulting with the relevant personnel of our firm.**

*This update is provided by our firm for informational purposes only and is not intended as legal advice.*

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