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Tax Implications for Non-Domiciliaries Becoming Domiciliaries of Israel and Non-Domiciliaries Investing in Israel under Israeli Tax Law

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Today, unlike in the past, the reality of moving from one country to another is becoming simpler and more common. Although such move can be a prolonged process taken in steps, it can also be as swift as an overnight plane ride. Despite such variations, the issue of moving from one country to another entails various tax implications requiring examination of when and how the change of domicile occurs, in which country one is obligated to pay taxes, and in which country would one be required to report the income earned. In this article, we will examine the tax implications of both ceasing to be Israeli domiciliary and becoming an Israeli domiciliary.

From the outset it must be noted that the tax related issue of residence is dependant both upon domestic laws of a given country and most importantly, upon provisions of various treaties promulgated with a purpose of avoiding double taxation by two or more countries. Said treaties aid in establishing one's domiciliary for tax purposes via various tests promulgated therein. It also must be noted that one could be a resident of more than one country or state, but the same individual may only have one domicile. Determination of one's domicile is dependant upon various activities an individual conducts in the country, but by and large is indicated by such individual's designation of a specific country as his or her primary current home. An individual is obligated to pay taxes in country of his or her domicile, but may also be required to pay taxes in countries of his or her residence.

For example, it is possible one could be

considered a domiciliary of Israel under the Israeli domestic law, and at the same time be considered a domiciliary of the United States for the purposes of tax assessment by the Internal Revenue Service under the United State Law. In case of such conflict, the question which law would apply to an individual can be resolved by various multi factor tests set down in the Tax Treaty between US and Israel.

Accordingly, one who is considered both a domiciliary of the US and Israel under respective domestic laws, shall be deemed a domiciliary of the country where such

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individual permanently resides. In the event the same individual has two permanent residencies in two countries or if he or she does not have a permanent residence in either country, the domicile of such individual shall be determined according to where such individual concentrates his or her vital interests.

If residency cannot be determined through the above test, then the relevant determination will be made in accordance with the laws of the country where such individual usually resides or spends most time. If domicile cannot be established under the latter test, then an individual in question shall be deemed domiciliary of the country where he holds citizenship. Finally, in the event our nomad individual is a citizen of both countries or of neither of the countries where the tax assessment

is to be made, then the taxing authorities of the countries in question are required to resolve the issue of residency by a mutual agreement.

Establishing Domiciliary Status According to Israeli Law

The Israeli Tax Revenue Law has undergone an extensive revision effective as of January 1st, 2003. The amendment resulted in major changes in the taxing methodology under Israeli law. For example, while previously the Israeli tax system was based on territorial taxation, i.e. a tax system that taxes domestic income but not foreign income, the Israeli tax law is based on personal taxation system whereby a taxpayer can now be taxed on his or her worldwide income.

Also, the new law amended the definition of a domiciliary of Israel for tax purposes. Under the new law, domiciliary is any individual whose “core of life activities” is located in Israel. In accordance with the Israeli domestic law, in order to ascertain what constitutes “core of life activities”, one must inspect an individual's familial, economic, and social connections and relations. The resulting evaluation determines the individual's domicile is. Other relevant factors in this context include physical location of the permanent residence of the individual, the residence of his or her family, location of an individual's regular employment or business, location of an individual's ongoing prevalent economic interests, and location of such individual's social activity, such as participation in various organizations, committees and the like.

Moreover, the new law establishes a number of rebuttable presumptions. For example, an individual who stays in

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Israel for a period of over 183 days is presumed to be a domiciliary of Israel. Also, if an individual has spent 30 days or more during the tax year in question **and** has also spent 425 days or more throughout the period of tax year in question and the two years prior thereto in Israel, then such individual will also be presumed to be a domiciliary of Israel. It should be noted in this context that the aforesaid rules are presumptions and can be rebutted by evidence establishing otherwise by either the individual or the relevant taxing authority inspector.

As demonstrated, determination of whether one qualifies as a domiciliary of Israel is of utmost importance as persons deemed

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domiciled in Israel are required to remit tax on their worldwide income, whether the source of such income is in Israel or not, unless a relevant exemption applies. However, an individual who is determined to be a non-domiciliary may also be required to pay tax (in accordance with the treaty) and under certain circumstances may be required to report income that has emanated from or has been collected in Israel. In this context we should turn to a discussion of tax obligations, benefits and exemptions relating to one’s change of residence and the status of domiciliary.

Change in Status of Domiciliary of Israel – Exit Tax

Under the new law there is a requirement of payment of what has been named the “Exit Tax”. This tax is assessed upon a domiciliary of Israel when he or she ceases to be a domiciliary and becomes a non-domiciliary. The tax is charged on the previously untaxed appreciated value of the taxpayer’s assets. Pursuant to the law any asset that belongs to a domiciliary will be considered as sold one day before domiciliary becomes a non-domiciliary. The presumed sale price is subject to the “Exit Tax”. Term asset includes any and all worldwide asset, including real estate, stocks and options, as well as employee stock options.

A domiciliary of Israel who becomes a non-domiciliary may be exempt from paying the tax charged for the period when such change occurs by paying the tax at the time of the actual sale of the asset instead of paying the tax when the change in status occurs. If a taxpayer did not pay the “Exit Tax” upon the change of status, then it is presumed that taxpayer “requested” to postpone tax assessment and payment until such time when he or she will actually sell the asset. The assessed capital gains tax will only be assessed as to the appreciation in the asset’s value from the date of purchase to the date a change of status occurs. However, if a given scenario involves sale of an asset in Israel that is unrelated to an individual’s domicile, such as a sale of real estate then the capital gains tax referred to above is assessed on profits gained at any time of sale, even if such sale happens subsequent to change in status.

It must be noted that in light of the fact that the new law went into effect on January 1st, 2003, the Israeli courts are yet to examine the issues relating to the new definition of a domiciliary

of Israel and the Exit Tax. From the few reported cases on the matter, it appears that the courts tend to view change of one’s residence as a prolonged process that does not conclude with one’s physical departure from Israel. Under such an interpretation, it is possible that the Israeli tax authorities will consider an individual a domiciliary of Israel intending to change his or her place of residence to another country for up to additional two years subsequent to departure from Israel.

Tax Relief and Exemptions for Non-Domiciliaries who Become Domiciliaries of Israel

Israeli legislature extends tax relief and exemptions to certain individuals who choose Israel as their new domicile. Certain benefits are also granted to foreign individuals and entities who seek to invest in Israel, but nonetheless remain in status as a non-domiciliary.

A non-domiciliary who chooses to also become a domiciliary of Israel can enjoy the benefits of tax relief and exemptions under Israeli law. The benefits allow the same individual to be exempt from tax assessments for a period of 5 years on such items of passive income as interest, dividends, royalties and

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income from rental properties. Said period of 5 years commences from the time when the individual officially becomes domiciliary of Israel. Said tax exemption is afforded to individuals so long as such passive income does not result from a business located in Israel owned or controlled by the individual becoming domiciliary of Israel throughout the period of change of residence. The same individual is also afforded a 4 year tax exemption on income from business he or she owned outside of Israel for at least 5 years prior to becoming a domiciliary of Israel.

Tax Benefits to Non-Domiciliaries Investing in Israel

In addition to benefits granted to new domiciliaries of Israel, the Israeli law grants tax benefits to individuals and entities that seek to invest in Israeli companies. Grant of such benefits is a self-evident endeavor of the Israeli legislature to encourage investment in Israel. For example, under section 97b of the Tax Law, non-domiciliaries benefit from a tax exemption on purchases of stock issued by an Israeli corporation after 2003, so long as such corporation was in the business of research and development. It is thus apparent that that the Israeli legislature sought to encourage investment in research and development by granting tax exemptions to non-domiciliaries on capital gains accumulated at the time of the sale of their stock.

Additionally, the Israeli legislature in its quest to encourage foreign investment in the stock exchange, granted a tax exemption on capital gains upon the sale of securities traded on the Israeli Stock Exchange (TASE). Such exemption applies, so long as the capital gain is not a result of investment emanating from a permanently established business in Israel.

In addition to said exemption, the Israeli legislature imple-

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mented a temporary exemption that is in effect between 1st of July, 2005 and August 31st, 2008. That exemption applies to capital gains on the sale of stock purchased during said period. Among additional requirements for qualifications for the exemption is the existence of a tax treaty with the country of domicile of the alien seeking to enjoy the exemption and various other requirements as contained within section 97 (3b).

Moreover, the 1959 law titled “Encouragement of Foreign Investment” establishes tax exemptions and benefits for various periods of time, among them tax relief in form of reduced taxation rates, reduced income taxation, and various types of

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relief related to dividend taxation emanating from the encouraged investment. This grants extensive benefits to foreign investors in Israeli companies. Under the 1959 law, foreign investment is defined as a direct or indirect investment of at least 5 million NIS in an Israeli company resulting in ownership of such company’s stock.

The law operates by increasingly lowering taxation rates as the investment amount goes up. The percentages of investment in companies are measured yearly, and tax benefits are extended based on such measurements. The law establishes that in a year where the rate of investment in the company is at least 49%, but lower than 74%, the tax rate shall not be above 20%. In a year where foreign investment stands between 74% and 90%, the tax rate is capped at 15%. Finally, if the amount of foreign investment is above 90%, then the tax rate shall not exceed 10%.

Conclusion

As shown, the process of changing one’s domiciliary status entails various complicated tax implications. While various benefits and obligations may arise from such transition, a carefully tailored analysis of the individual’s assets and income is an absolute must in order to ascertain what types of tax relief are available under Israeli law. Such analysis is also necessary so as to avoid any unpleasant consequences of infringing the Israeli Tax Law.

