



Legal Update

May 2015

FBC Tax Department

Israeli Tax Authorities Draft Circular regarding internet activity of foreign companies in Israel

Dear clients and colleagues,

On April 2, 2015, the Israel Tax Authority (the "ITA") published a draft circular for public comment concerning the taxation of foreign corporations operating in Israel via the internet, such as Facebook and Google (the "**Draft Circular**"). Currently, these corporations do not pay tax in Israel on the revenues from services they provide in Israel, such as advertising or search engine optimization, because under double tax treaties and general international tax principles, corporations are obligated to pay tax only in their country of registration, unless they have a permanent establishment in the country in which they are active. According to the traditional rules of international taxation, it is difficult to define where business activities are conducted when they are carried out via the internet, and the accepted criteria set out in tax treaties, including those signed by the State of Israel, lead to a situation where multi-national companies operating via the internet, are not obligated to pay tax in countries where their services are used.

The OECD and the countries of the G20 have identified the inherent problems regarding activities conducted via the internet, and several interim reports, published by the OECD as part of its BEPS (Base Erosion and Profit Shifting) project, discuss the need to adapt existing tax regulation of economic activity carried out currently by international companies via the internet. The OECD pointed to the need for international cooperation in order to arrive at a uniform amendment to international taxation rules, in order to prevent situations where each country taxes the activities in its territory, leading to chaos and double taxation.

The ITA has not waited for the final conclusions of the OECD on this issue, and moved ahead to publish the Draft Circular. The Draft Circular outlines the situations in which the income of a foreign corporation that provides services via the internet to Israeli residents will be deemed as having been generated via a permanent establishment in Israel, and hence will be subject to taxation in Israel.

The ITA's approach tries to change the traditional test for permanent establishment in relation to businesses that do not have any physical presence, using an administrative order. We believe that such a dramatic change in international taxation principles should be implemented via statutory change, rather than via administrative orders of the tax authorities, as was done, for example, in England. Moreover, as a matter of domestic law, administrative orders cannot override international tax treaties because of their status under the law.

The indicia of permanent establishment that the ITA wishes to adopt are broad and abstract, and would include many activities, whose sole connection with Israel is that they are "utilized" by Israeli residents. Thus, for example, the Draft Circular dictates that where a foreign corporation operates a website optimized for use by Israeli customers, or where the website is widely used by Israelis, the corporation will be considered as having a permanent establishment in Israel and this will be subject it to taxation in Israel. These tests are far-reaching; websites such as EBay or AliExpress would easily fall within the framework of these tests, and as a result, would be required to register for VAT, and to pay corporate tax in Israel in respect of sales to Israeli residents, even where the sales were effected by suppliers or manufacturers that are not Israeli residents. In these cases, the foreign companies would not be obligated to pay tax in Israel, if they did not conduct their activities via the internet. Thus the implications of the Draft Circular are far-reaching, in that it discriminates between corporations operating from countries that have a treaty with Israel and those operating from countries that do not. In addition, the rules are applied differently between manufacturers that sell products to Israel by means other than the internet, and those that operate via the internet.

We outline below the situations described in the Draft Circular that may establish a permanent establishment in Israel with regard to income tax and VAT. We underscore that the finding of a permanent establishment in relation to income tax may impact the ITA's position with respect to VAT registrations.

Tests for establishing a permanent establishment in regard to income tax under the Draft Circular

- A permanent establishment can be established even when the service is provided without physical presence.
- The activities of foreign corporations carried out at times via physical facilities their own (or related parties') in Israel will be regarded as having established a permanent establishment.
- When specific indicia are established, in whole or in part, whether the activities of the foreign corporation are deemed to constitute a permanent establishment in Israel needs to be examined. Examples of such indicia in the Draft Circular include: (1) whether the foreign corporation operates a website optimized for use by Israeli customers (language, advertisements, style, currency, etc.); (2) the website connects Israeli customers with Israeli suppliers; (3) the popularity of the website among Israeli users; (4) whether the ability to increase profits from the website rises as the number of users and activities on the website grows.
- The formal engagement of an employee by a company (where the company is resident in Israel), who acts according to instructions from the foreign corporation, or where the foreign corporation is involved in the recruitment and determination of conditions of employment of employees in Israel, may deem the foreign corporation to have a permanent establishment in Israel.
- A broader approach may be adopted to change the traditional test of permanent establishment in relation to businesses that do not have any physical presence. In such a case, the existence of a permanent establishment will be considered where a significant number of contracts for the provision of digital services are concluded between the foreign corporation and Israeli residents via the internet only.
- Activities of a foreign corporation are performed at times with the support of related Israeli companies or via Israeli contractors. These may be considered to be "dependent agent(s)" and will create a permanent establishment in Israel. This is especially the case where the scope of authority provided to the agent in Israel is high. For example, where the scope of authority of the agent allows it to intervene in negotiations for the conclusion of a contract between the Israeli customer and the foreign corporation, the likelihood of the agent being treated as a dependent agent increases. In addition, where the agent can provide assurances to customers in relation to prices and commercial conditions, in a manner that obligates the principal company, the agent will be deemed a dependent agent and thus a permanent establishment of the foreign corporation in Israel will be established.

Tests for establishing a permanent establishment in regard to VAT under the Draft Circular

A foreign corporation conducting business activities in Israel is considered as a business which is required to be registered as an authorized dealer, whose transactions constitute business activities subject to VAT. Therefore, corporations that are considered to be conducting business activities in Israel are obligated by the tax authorities to register in Israel for purposes of VAT.

- Examples of the existence of business activities in Israel detailed in the Draft Circular are: (1) the foreign corporation supplies services utilized in Israel; (2) service is provided to Israeli customers to direct them to Israeli users and vice-versa.
- Additional circumstances that require the registration of foreign corporations include: (1) a foreign corporation operating a search engine will be required to register in relation to the revenue from Israeli customers where it provides them with advertising services directed at Israeli consumers or users; (2) a foreign corporation operating a website for booking accommodation at Israeli hotels is required to register in relation to its revenue in connection with the booking for hotel accommodation in Israel by Israeli consumers.
- A foreign corporation that is deemed subject to income tax because of the establishment of a permanent establishment in Israel is presumed to operate a business in Israel, and therefore must register for VAT in respect of its transactions with Israeli customers.
- An Israeli business which sells intangible assets or provides services to a foreign corporation which is required to register for VAT in Israel will be subject to full VAT in connection with its transactions with the foreign corporation which is taxed in Israel.

As the foregoing indicates, the ITA intends to widen significantly the interpretation given to permanent establishment and ITA's "activities in Israel" that require registration with regard to VAT. The significance of the ITA's position is to impose VAT (currently at a rate of 18%) on the services provided to Israeli residents and the payment of corporate income tax (currently at a rate of 26.5%) on revenues from these activities. This would be a very heavy tax burden on international corporations active in Israel via the internet.

We would welcome the opportunity to discuss with you the potential impact of the anticipated change in the Israeli tax authority's approach to cross-border taxation of companies acting through the internet, and to explore with you how we may be in a position to assist you in building a strategy to address this development.

Sincerely,

**FBC Tax Department
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