



Update

June 2016

FBC Tax Department

Non-resident company activity in Israel through the internet

Dear Clients and Colleagues,

We write to inform you about Circular 4/2016 (the "**Circular**") which was published by the Israeli Tax Authority (the "**ITA**") with regard to non-resident company activity in Israel through the internet. This newsletter summarizes the key provisions of the Circular.

1. Background

In recent years there has been an increase of economic activity using the internet globally, including in Israel (hereinafter: the "**Digital Economy**"). The internet sector has seen acceleration in both areas of providing goods and services. Internet transactions are also carried out between non-resident companies with customers in Israel, either directly or indirectly, through an intermediate company or through subcontractors or representatives who carry marketing activities in Israel; locating Israeli customers; providing business support and/or technical services to Israeli customers etc., in exchange for payment.

In some circumstances, in order to provide the services or sell the goods to the Israeli customer, the non-resident company creates a designated website in Hebrew for the Israeli users/web surfers. In other cases, the international website is the platform that Israeli customers use for the ordering of goods and services. Often the non-resident company provides advertising or agency services to the Israeli customers on other websites.

The purpose of the Circular is to explain in what situations the income of a foreign resident company, from the sale of products or providing services, through the internet, will be viewed as income of a "permanent establishment" ("**PE**") in Israel and to determine the attribution rules for the income to the PE. The Circular clarifies also the treatment of these cases in relation to non-resident companies that are not resident of contracting states under tax treaties ("**Treaty Resident**") and explains when international companies are required to register as an approved dealer for VAT purposes and report accordingly.

2. Income Tax Perspectives

2.1 Activity in Israel of a foreign resident company that is a Treaty Resident – examining whether it has a PE in Israel

In case of a Treaty Resident, Israeli tax liability applies only to the extent that the foreign resident company has a PE in Israel, as defined in the OECD Model Tax Convention, meaning either of the two following alternatives needs to exist:

- (a) The main business activity in the contracting state is carried out through a fixed place available to the foreign company. According to the OECD commentary on the Model

Convention (the "**Commentary**"), in the context of electronic commerce, the physical location of the server, which supports the website, may be considered as a fixed place of business, which creates a PE in Israel for the foreign company. Notwithstanding, the Commentary does not deny the existence of PE's in other places where there is business activity, even when the server is located at a different location. According to the interpretation expressed in the Circular, in light of the current Digital Economy where a server can be located in any place in the world while the marketing, service, support, the development, etc. can take place in other locations, the physical location of the server is given relatively little weight in determining the existence of a PE. The Circular also indicates that in cases where the foreign company has a physical presence in Israel, such as existence of a branch of the foreign company, or the leasing of offices, those places will be considered as a PE. In addition, according to the Circular, when the representatives and employees of the foreign company make permanent use of offices of an Israeli resident company that is related to the foreign company for the production of income, which is not the Israeli company's income, the foreign company may have a PE in Israel. Due to the Digital Economy, the Circular notes that activities previously considered as "preparatory and auxiliary" can nowadays be deemed to be principal activities of the company and the company will be considered having a PE in Israel.

In addition the Circular lists the following indicators of the existence of a significant digital presence in Israel:

- A significant number of digital service contracts are executed online with Israeli residents.
- Services that the foreign company provides are used by many customers in Israel through the internet.
- The foreign company provides service on the internet that is adapted to Israeli customers or users (for example: the use of the Hebrew language, the charging of customers with the Israeli currency, the clearing of local credit cards in Israel, etc.)

(b) The business activity in the contracting state is carried out through a dependent agent (hereinafter: "**Dependent Agent**"), who has the authority to enter into contracts in the foreign company's name. The Circular lists the following indicators that can assist in determining whether the activities of the agent in Israel for the foreign company are those of a Dependent Agent which creates for the foreign company significant economic activity constituting a PE in Israel:

- The foreign company's lack of involvement in the transaction demonstrates that in practice authority has been granted to the agent in Israel.
- The agent in Israel receives orders from customers that are approved in a routine manner by the foreign company.
- The agent in Israel is significantly involved in adapting to Israeli customers' demands.
- The agent in Israel is a party to the contract between the foreign company and the customer.

All of the aforementioned indicators should be evaluated, and if there is a high degree of involvement of the agent in Israel in the negotiations, and his decisions bind the foreign company, these findings will strengthen the conclusion that a Dependent Agent exists that creates for the foreign company substantial economic activity constituting a PE.

2.2 The activity in Israel of a foreign company that is not a Treaty Resident

When a foreign company, which is not a Treaty Resident, carries out internet activity in Israel, Israeli tax liability is determined based on internal Israeli Law, regardless of the PE requirements according to the Israeli tax treaties. According to the Israel Income Tax Ordinances (the "ITO"), a foreign company is liable for tax in Israel on income generated from business activity in Israel, which can result from either a physical presence or a significant economic presence.

- 2.2.1 Carrying out business activity in Israel through a physical location in Israel – The activities of foreign companies that are not Treaty Residents that provide services or sell products through the internet are often carried out through a physical location in Israel, such as an office where the foreign company has employees and provides services to its customers, etc., which will be deemed to be the place of business activity of the foreign company in Israel.
- 2.2.2 Carrying out business activity in Israel with the assistance of an agent in Israel – When an agent in Israel or an affiliated party that is resident in Israel (including an affiliated Israeli resident company) (hereinafter: "**Agent in Israel**") assists the foreign company in providing its services or selling its products in Israel (which could include the following activities: finding customers or collecting data, managing customer connections, providing marketing, collection, support, consulting, or customer support services, etc., through the Agent in Israel), such activities, in whole or in part, in combination with the internet activity of the foreign company in Israel, will be deemed business activity taking place in Israel under the ITO.
- 2.2.3 Significant economic presence of the foreign company in Israel – A foreign company that provides services through the internet alone, without having any physical presence in Israel, will be deemed to have business activity in Israel if its economic presence in Israel is significant. The following are a number of indicators that can demonstrate the existence of a significant economic presence of a foreign company in Israel:
- The foreign company provides its customers with services on the internet, such as advertising, agency, marketing, support etc., in relation to its Israeli users.
 - The foreign company carries out a substantial number of transactions with residents of Israel through the internet.
 - The foreign company provides service on the internet adapted to Israeli customers or users (for example: the use of the Hebrew language, style, the charging of customers with the Israeli currency, the clearing of local credit cards in Israel, etc.).
 - The services that the foreign company provides are used by many customers in Israel through the internet.
 - The proportion of Israeli users of the website is high.

3. Attribution of profits

3.1 Attribution of profits of a foreign company resident in a treaty state to a PE in Israel

Under the Authorized OECD Approach ("A.O.A."), the profits attributed to the PE are the profits that it could have earned under the arm's length principle, if the PE were a separate entity. Attribution of profits is done in two steps. First, significant people functions relevant to the attribution of economic ownership of assets and to the assumption of risks are identified and attributed to the PE. Second, transactions between the PE and the foreign company of which it is a part (the "**Internal Dealings**")

are priced on an arm's length basis, which in turn makes it possible to price the internal dealings in accordance with transfer pricing guidelines.

3.2 Attribution of profits of a foreign company in Israel that is not a Treaty Resident

When a foreign company that is not a Treaty Resident conducts business activity in Israel, a Functions, Assets and Risks evaluation must be carried out to attribute the appropriate amount of profit for its activity in Israel. If the foreign company has a PE in Israel, separate reporting of its income in Israel is required. The profit made in Israel and attributable to its activity in Israel is determined by the transfer pricing guidelines. If the foreign company has an affiliate or subsidiary in Israel, it is necessary to distinguish between the reporting of the affiliated Israeli company and the reporting of the foreign company.

4. VAT Perspectives

Providing services through the internet to residents of Israel constitutes a transaction in Israel, which raises the issue of registration as an approved dealer in Israel for VAT purposes. The Israeli Value Added Tax Law requires that a foreign corporation register for VAT and appoint an Israeli representative if it carries out business in Israel. It is noted in the Circular that a foreign corporation may be regarded as carrying out business in Israel where the foreign company meets any of following conditions: (i) The activities of the foreign company for the purpose of income tax constituting a PE in Israel; (ii) The foreign company has a branch in Israel and/or it employs Israeli employees and/or leases offices in Israel, etc.; (iii) The foreign company has business activities for providing services in Israel with the assistance of or in cooperation with an Israeli representative/Israeli affiliate; (iv) The foreign company has a significant economic presence in Israel.

Please contact us in relation to any questions or clarifications. We would be delighted to assist you in any way.

Sincerely,
Tax Department

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