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Israel

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Israeli court addresses "management and control" issue

Overview

The Israeli District Court in Tel-Aviv recently ruled that a company established under the laws of a foreign jurisdiction is considered an Israeli tax resident by virtue of its management and control ("M&C").

The M&C concept under Israeli domestic tax law

Since 2003 an Israeli tax resident generally is subject to tax in Israel on its worldwide income. A company generally is considered an Israeli tax resident for a tax year if either it is incorporated in Israel or the M&C of its business is performed from Israel.

The M&C determination is relatively complex and requires a thorough analysis of the relevant facts on a case-by-case basis. The Israeli Tax Authority ("ITA") in 2004 issued a circular outlining its position on the M&C issue. The circular provides guidelines and focuses on several factors, including the board members' identity and fiscal residency, the place where the corporation strategizes and formulates its general business policy decisions, the location of general shareholder meetings, the location of the corporation's business facilities, and the nature of daily management activities.

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As the Israeli courts rarely have addressed the M&C issue, this decision constitutes important guidance with respect to the M&C concept for Israeli tax purposes, even though a district court decision is not binding precedent.

Key facts

In 1990, certain Israeli tax resident individuals (the "taxpayers" or "shareholders"), the owners of an Israeli resident textile company, established a company in the Bahamas to engage in the export of textile products. In 1996, pursuant to an agreement between the Israeli company and the Bahamian company, the latter sold its business activities to the Israeli company and then distributed its earnings as a dividend to its shareholders.

The main controversy between the taxpayers and the ITA related to the tax treatment of the dividend income for Israeli tax purposes, which in turn depended on the tax residency status of the Bahamian company.

In general, for the years in question Israel had a territorial tax system under which an Israeli tax resident was subject to tax on dividends distributed by a foreign company only if the dividends were received in Israel or if the dividend income was considered Israeli-sourced, which was the case if the company distributing the dividend was considered resident in Israel for tax purposes. Consequently, the determination of residency of the company was crucial to determining the taxation of the dividend to the shareholders. The test for determining a company's tax residency was the same as it is now, under which a company was resident in Israel if either it was incorporated in Israel or its business was managed and controlled therein.

The taxpayers cited the following facts to support their argument that the M&C of the Bahamian company was not performed from Israel:

- the Bahamian company's board of directors was comprised of non-Israeli tax residents;
- board meetings were held outside Israel and without any shareholder involvement;
- daily management activities were performed outside Israel; and
- the Bahamian company had offices in Amsterdam and New York, in addition to its main office in Switzerland, and no offices in Israel.

The ITA challenged the taxpayers' position, claiming that the Bahamian company's major business operations were actively managed from Israel by the taxpayers' sons, so the Bahamian company should be considered an Israeli tax resident by virtue of its M&C, resulting in Israeli taxation of the dividend income in the hands of the Israeli shareholders.

The District Court's findings and conclusion

In analyzing the Bahamian company's residency for tax purposes, the court examined various factors, including the following:

- The material business activities of the company were conducted through the Israeli company and, in practice, the actual decision-making process was undertaken in Israel by the taxpayers' sons, who were actively engaged in the business activities on behalf of the Bahamian company, including execution

of contracts and active involvement in decision-making relating to customer relationships.

- The company had no significant physical substance in the Bahamas. The Bahamian company could have conducted its business activity elsewhere (or even electronically). Furthermore, the Israeli company and the taxpayers' son led the marketing activity that was performed in the United States; and the Bahamian company did not receive the professional resources to perform the marketing activities needed to fulfill its business purpose.

- The court emphasized that the company's substantial management and business activity was performed not by the Bahamian company but rather by the Israeli company, through the individuals present in Israel. Also, the directors of the Bahamian company were not involved in the Bahamian company's business activities.

- All business correspondence took place in Hebrew, which the appointed managers of the Bahamian company could not read or speak, rendering them entirely dependent on the taxpayers' son. According to the court, this supported the conclusion that effective management of the Bahamian company was conducted not by the Bahamian company's management but instead by the Israeli company or the taxpayers' son, from Israel.

The court emphasized that use of the corporate legal form is not sufficient to substantiate a separate independent company for tax purposes, and that the corporate platform established outside Israel was artificial and had no material impact on the business operations of the Bahamian company. Consequently, existence of the formal corporate mechanism outside Israel does not necessarily lead to the conclusion that an independent entity exists for tax purposes that is separate from the Israeli resident company. Rather, the court emphasized the significance of examining the day-to-day management of the company's activities.

The court concluded that the place where the company determines material business policy and makes strategic business decisions is the place to consider for Israeli tax residency purposes. As all of the material managerial activities and decisions were performed in Israel, the company should be considered an Israeli tax resident company in the relevant tax years by virtue of its M&C. Therefore, the court held that the dividend distributed by the Bahamian company was Israeli-sourced and taxable to the Israeli-resident shareholders.

Note that the foreign entity in this case was established in a country that does not have a tax treaty with Israel. The court, therefore, did not have to address the interplay between the determination of a company's tax residency by virtue of its M&C under Israeli domestic law and the determination of its tax residency under tax treaty provisions.

Insights

This decision is one of very few handed down by the Israeli courts that address the M&C issue, so it provides important guidance in this area. Therefore, US and other foreign investors with substantial operations or functions in Israel may wish to examine the potential tax implications from a classification of entities incorporated outside Israel as Israeli tax residents when there is significant Israeli managerial involvement in the business affairs of the foreign-incorporated entity.

Note that the decision could affect tax years that are still open for examination by the Israeli tax authorities. Companies may wish to consider and, if appropriate, account for potential risks and any related financial statement impact.

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