**Israeli Tax Authority releases first guidance related to e-commerce**

*April 21, 2016*

**In brief**

The Israel Tax Authority (ITA) on April 11, 2016, published Circular 4/2016 (the Circular), which addresses taxation of foreign companies that operate in Israel through e-commerce and online services (also known as the ‘digital economy’).

The Circular represents the first time the ITA has published its views on online service income and income from the sale of products generated by a foreign company online. The Circular also describes the tax treatment of such companies residing in countries that both have and have not entered into a tax treaty with Israel.

The Circular also addresses when a foreign company providing services via the internet must register for Israeli value-added tax (VAT). Taxpayers should review the ITA’s guidance if they generate or intend to generate e-commerce income from Israeli customers.

**In detail**

**Background**

Online economic activity by multinational companies has increased globally, including in Israel. Such online activity includes international sites that serve as platforms for the provision of advertising, brokerage, marketing, and similar services to Israeli customers.

The Circular provides guidance on permanent establishment (PE) treatment and income attribution rules for foreign companies selling products or providing services online to customers in Israel. It also clarifies the tax treatment of foreign companies that are not residents of contracting states under tax treaties, and explains when international companies are required to register and report VAT, as mentioned above.

Importantly, the Circular does not define many key terms, such as ‘substantial number,’ ‘many customers,’ and ‘high usage.’

**Income tax aspects**

**When are activities taxable?**

The Circular distinguishes between companies residing in a country that maintains a treaty with Israel (Treaty Residents) and those that are not Treaty Residents. The latter are subject to domestic Israeli tax law provisions without treaty protection.
Treaty Residents
For Treaty Residents, Israeli tax liability applies only to the extent the foreign company has a PE in Israel, as defined in the OECD Model Tax Convention, meaning either:

- the company has a fixed place of business through which it carries on its business; that is, the key features are a physical, fixed place of business where the foreign company is carrying on its business;
- the company conducts its activity using a dependent agent that has authority to enter into contracts in its name.

Fixed place of business
Under current OECD guidelines, the location of physical servers is a central factor and its presence in Israel may be considered a fixed place of business, which creates a PE in Israel for the foreign company.

The Circular modifies this approach and interprets the definition of fixed place of business in light of the current digital economy, where a physical server can be located virtually anywhere in the world. According to the Circular's interpretation, the physical location of the server is given low weight in determining the existence of a PE, while the place where marketing, service, support, development, and other important functions are carried out is given more weight.

The Circular also indicates that physical presence in Israel can result from, among other factors, a branch of the foreign company in Israel or renting offices or facilities that are used in its activity. In addition, under the Circular, when representatives of a foreign company make continuous use of offices of an Israeli-resident company that is related to the foreign company to promote generation of income by the foreign company, the foreign company may have a PE in Israel.

The Circular notes that when the activity of the foreign company is only of a preparatory and auxiliary character, no PE is created. However, certain activities that go beyond this exemption can create a PE, such as identifying potential clients, marketing, customer relations management, and conducting market surveys.

Due to the unique nature of electronic commerce, the Circular notes that activities previously considered ‘preparatory and auxiliary’ now might be considered the primary activities of a company. For example, while a foreign company’s significant digital presence in Israel and fixed place of business previously would have been considered preparatory and auxiliary, those factors now might constitute a PE because the activities are no longer considered merely preparatory and auxiliary, but rather main activities of the foreign company. The Circular lists the following indicators of significant digital presence:

- A substantial number of digital service contracts are executed online with Israeli residents
- Services that the foreign company provides are used online by many customers in Israel
- The foreign company provides online services tailored to Israeli customers or users, such as through the use of the Hebrew language or Israeli currency.

The Circular adds that when a foreign company has a significant digital presence in Israel, a possible claim by an ITA inspector for the existence of a PE shall require consultation with the International Unit of the Professional Division and the Legal Department of the ITA.

Dependent agent
A dependent agent generally is a person or company authorized to enter into contracts in the name of another enterprise and who has habitually exercised that authority for business activities.

The Circular indicates that if a contract is signed by a foreign company as a formal act (for example, the foreign company lacks involvement) while the significant work leading to the contract was done through the Israeli agent (such as negotiation of binding commercial terms, contract customization for the client, or inclusion as a party to the contract), the agent might be viewed as having the authority to enter into contracts, which creates for the foreign company significant economic activity constituting a PE for the foreign company.

Non-Treaty Residents
For companies that are not Treaty Residents, Israeli tax liability is determined based on Israeli tax law, regardless of the PE test used in Israeli tax treaties.

Under the Israel Income Tax Ordinance, 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.

Physical presence
The characteristics of the digital activity can suggest that the business activity was generated in Israel; for example: if the foreign company has a physical place in Israel, such as an office, has employees in Israel, or has a location in Israel where it can
provide customer service or enter into customer transactions.

Physical presence also may exist when a foreign company receives assistance in its Israeli operations from a representative entity in Israel, which could include a related Israeli-resident company that is involved in finding customers, gathering information, customer service, or maintaining customer relationships.

**Economic presence**

A foreign company that provides only online services without a physical presence in Israel will be considered to perform business activity in Israel if it has significant economic presence in Israel. Indicators of significant economic presence include the following:

- The foreign company provides online services such as advertising, brokerage, marketing, or support for Israeli users or customers
- The foreign company performs a substantial number of online transactions with Israeli residents
- The foreign company provides online services that are adapted to Israeli customers or users, such as by using Hebrew or Israeli currency
- Services that the foreign company provides are used online by many customers in Israel
- There is high usage by Israeli customers of the foreign company’s internet site
- The consideration paid to the foreign company is highly correlated with the extent of online use by Israeli customers.

The Circular adds that in cases involving a foreign company with significant economic presence in Israel, a claim by an ITA inspector that such a presence could lead to a PE requires consultation with the International Unit of the Professional Division and the Legal Department of the ITA.

**Attribution of foreign-company profits to Israeli PE**

**Treaty Residents**

The Circular indicates that the attribution of profits of a foreign company to a PE in Israel should be done at arm’s length using the ‘functionally separate entity approach,’ which is described in a 2010 OECD report entitled Attribution of Profits to Permanent Establishments. The PE should be viewed as if it were a separate and independent enterprise from the foreign company, engaged in the same or similar activities under the same or similar conditions, to determine what profits the PE would earn, based on the nature of the functions performed by the PE, the assets used, and the risks assumed.

Profits are attributed using a similar method when a dependent agent constitutes a PE, considering the proportional income of the PE of the foreign company. According to OECD publications, attribution of profits between a PE and the related foreign company should be done at arm’s length based on the ‘significant people functions’ approach, which allocates activities, assets, and risks based on weightings of significant people functions that are relevant to the PE.

**Non-Treaty Residents**

For companies that are not Treaty Residents, profits are attributed by identifying the functions, assets, and risks (so-called FAR analysis) of the Israeli activities.

**Reporting to the ITA**

If the Israeli tax authorities determine that the activities of a Treaty Resident create a PE in Israel, the foreign company will have to report its Israeli income separately, meaning full separation between the foreign company’s reporting and the reporting of any related companies or subsidiaries in Israel.

When examining the possible existence of an Israeli PE and the attribution of profits, the ITA can require the foreign company and the related Israeli companies to provide information regarding functions performed in Israel, income, turnover from clients, and expenses related to the various activities.

These rules also will apply to foreign companies that are not Treaty Residents, modified as needed.

**VAT considerations**

The requirement for foreign companies to register for VAT purposes in Israel is established by Section 60(a) of the VAT Law, which states that foreign residents and entities with business or activity in Israel must appoint a representative to be an ‘authorized dealer’ whose permanent place of residence is Israel, within 30 days after beginning the business or activity.

The Circular requires that a foreign company rendering online services to Israeli-resident customers will be considered to have a business in Israel under Section 60 of the VAT Law if one of the following criteria is met:

- The activity of the foreign company for income tax purposes constitutes a PE
- The foreign company has a business mechanism in Israel, which could be a branch or employees in Israel, a rented office in Israel, or an affiliate in Israel
- The company business activity has, or is assisted by, a representative in Israel or by an Israeli affiliate. Such
services may include identifying potential clients, information collection, customer relations management, marketing, collections, support consulting, or customer services.

- The company has significant economic activity in Israel, as discussed above according to ITA directives. This requires a facts-and-circumstances preliminary review by the Professional Division of the Customs and VAT Department.

A foreign company that provides online services to Israeli-resident customers and has business in Israel under one of the criteria above must register as a dealer in Israel and appoint a representative on its behalf. A foreign company that is required to register will not be considered a foreign resident for purposes of Section 30(c) of the VAT Law, which applies a 0% VAT to services or the sale of intangible assets by Israeli residents to foreign companies.

**Note:** The duty to report applies only to transactions with Israeli residents.

**The takeaway**

The Circular is a major Israeli corporate tax and VAT development, requiring taxpayers to undertake a prompt analysis and examination of their particular facts and circumstances. Taxpayers therefore should review the guidance and understand the tax implications and the necessary actions to take for applicable activities.

**Let’s talk**

For a deeper discussion of how this might affect your business, please contact:

**International Tax Services**

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