
New Israeli deemed distribution rules – intercompany loans, balances, and guarantees should be reviewed

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In brief

Further to an amendment to the Income Tax Ordinance (ITO), multinational companies with Israeli affiliates having intercompany loans, outstanding balances, or guarantees which exceed ILS 100,000 as of December 31, 2016, might trigger a deemed distribution tax event for 2017. Companies should review potential deemed income and withholding tax implications that may arise in their specific situations. Where relevant, consideration should be given to repaying amounts due before December 31, 2017.

In detail

ITO amendment

Effective January 1, 2017, Section 3(i1) of the ITO was introduced which states that a “withdrawal from a company, at the tax event date, shall be considered as income of a substantial shareholder.” Each of the terms has important significance and are defined in the ITO as set out below.

Withdrawals

A ‘withdrawal from a company’ is a “withdrawal of funds from the company by a substantial shareholder or its relative, or the placing of an asset of the company for their use, whether directly or indirectly, other than a withdrawal or use of an asset

that constitutes income which is fully taxed.”

Our discussion in this Tax Insight focuses on the ‘withdrawal of funds’ and its potential tax implications.

The term ‘withdrawal of funds’ is defined to include, *inter alia*, a loan, borrowing, or any other type of indebtedness, cash, securities, deposits, or any other guarantee that the company established as any type of collateral for the benefit of the substantial shareholders. It should be noted that this broad definition does not necessarily require that there be a cash outflow from the company.

This term ‘withdrawal of funds’ does not include when the accumulated withdrawal of

funds did not exceed on any day during the current or prior tax year the amount of ILS 100,000.

In the case of an indirect withdrawal only, a loan given to a company that serves a business purpose for the borrower company shall not be viewed as an indirect withdrawal from a company if the borrower company is not transparent. A ‘transparent company’ means for this purpose a company whose income is attributable to its interest owners, except in the case when all of the interest owners are companies subject to Israeli corporate tax.

Tax event date

The ‘tax event date’ in the case of a withdrawal of funds is the

end of the tax year after the tax year in which there was a withdrawal.

Substantial shareholders

Originally, in the legislative commentary on the proposed Section 3(i1), the stated objective was to relate to withdrawals made by individual shareholders only and in fact, the draft amendment only referred to individual shareholders.

However, the ITO provision that was eventually legislated refers to withdrawals by 'Substantial Shareholders' which generally is defined in the ITO as a shareholder having a 10% or more means of control in the company. Also included are 'relatives' to the Substantial Shareholder, which has a detailed definition in the ITO (hereafter the 'Substantial Shareholder').

Technically, the ITO provision appears to include Israeli resident and foreign resident companies and individuals.

Income treatment

Income from the withdrawal, at the tax event date, shall be income to the Substantial Shareholder in accordance with the following ordering rules:

- Dividend Income — if the company from which the withdrawal was made has 'profits' as defined in the Israeli Companies Law;
- Employment Income — if there are no profits and there is an employer-employee relationship between the company and the shareholder who is an individual; or
- Business Income — if there is no employer-employee relationship.

Calculation of withdrawal amount

The withdrawal amount for these purposes is calculated as the amount of the withdrawal less:

- the credit balance due to the Substantial Shareholder that took the withdrawal, as reported on the company's financial statements; and
- the amount of a loan that the company received from a banking institution for a period of at least two years, which was transferred within sixty days to the Substantial Shareholder, who bears all costs of the loan, provided that the Company did not establish a guaranty against that loan.

Credit balances are defined as balances available for offset permitted by law, including capital notes issued up to five years.

Funds that are returned to the company before the tax event date and are withdrawn again within two years of the date they were returned, shall be viewed as not having been returned up to the amount that was withdrawn again, unless the subsequent withdrawal happened only one-time and the funds were returned within sixty days.

Transitional relief

Under transitional relief provisions, the tax event shall not apply for 'withdrawals of funds' that are recorded in the company's financial statements as of December 31, 2016, provided that the funds are returned to the company by December 31, 2017.

ITA tax circular

The Israeli Tax Authority (ITA) has issued a tax circular, which explains the ITA's interpretation of Section 3(i1) (the Circular). The Circular in certain instances provides a lenient

interpretation of the ITO provision while in other cases it adopts a strict interpretation.

It should be noted that an ITA Circular is not necessarily binding on the Israeli courts when ruling on a tax issue.

We set out below certain key points expressed in the Circular regarding the abovementioned topics.

Withdrawals between Israeli companies

Since dividends between Israeli companies generally are not subject to Israeli tax, dividend income arising from withdrawals of funds between Israeli companies generally should not be taxable.

The Circular adds that the business and employment income classifications in this provision which apply when there are no earnings, shall not apply when the receiving party is an Israeli company subject to Israeli corporate tax (or if it is a foreign company that is not transparent for tax purposes).

Therefore, in essence, these deemed distribution rules should generally not apply to withdrawals between Israeli companies.

Business purpose exception for indirect withdrawals

The Circular emphasizes that the 'business purpose' exception stated in the ITO provision regarding indirect withdrawals only applies to 'loans.' According to the Circular, to be considered a 'loan' there must be a loan agreement, set interest rate, principal and interest repayment schedule, and borrower loan security.

A loan shall be considered as being used for 'business purposes' if it is a loan used by the borrower company for its own purposes and not for the

purposes of its shareholders. In an example provided by the Circular, a loan shall be considered taken for the benefit of its shareholders, if it is taken to repay a debt owed by the company to a third party, which if it would not have been repaid near the date of the loan, would have required personal guarantees given by the shareholders of the borrower company to have been realized.

Dividend classification — profits on consolidated basis

For purposes of determining if the income should be classified as a dividend (i.e., if there are profits), an indirect withdrawal shall be considered a withdrawal from the first company from which funds are withdrawn. However, in the case of a chain of companies (e.g., parent and subsidiary companies), the amount of profit reserves should be computed on a consolidated basis.

Indirect withdrawal parties

The Circular illustrates the case of 'indirect withdrawals' to include:

- a withdrawal made from a subsidiary in the group that is not directly held by the recipient company; or
- a loan or debt given by a company having a Substantial Shareholder who is also a Substantial Shareholder in the company receiving the loan or debt (i.e., loan between sister companies); and
- a loan from a company to a partnership that has a partner who is a Substantial Shareholder in the lending company.

Withdrawals — guarantees

Regarding guarantees for the benefit of the Substantial Shareholder, the Circular's example is that the amount of a bank deposit used to guarantee a debt owed by a Substantial

Shareholder or its relative shall be viewed as the withdrawal amount for these purposes. However, the Circular states that a general guarantee without specific assets designated, generally shall not be viewed as a withdrawal of funds.

Credit balances to substantial shareholders

The Circular points out that credit balances which may be offset in determining the withdrawal amounts do not include share capital, premium, and other types of capital.

Expense treatment

The Circular states that if the withdrawal is income to be taxed as employment or business income, an expense may be recorded in the company deemed making such payment, if for accounting purposes the withdrawal was closed out against the balance due.

Transitional relief — return of funds

For the transitional relief in returning funds by December 31, 2017, the Circular clarifies that returns of funds also includes payments to the shareholders of dividends, salary, and the like.

The takeaway

It is important that multinational companies should examine if intercompany loans, outstanding balances, or guarantees having a value over ILS 100,000 as of December 31, 2016 might trigger a deemed distribution tax event for 2017. When applicable, consideration should be given to settling these amounts by December 31, 2017 in order to not have a tax event occur in 2017.

Moreover, future financing between related companies should be carefully reviewed to understand the impact of these new tax rules and how to

efficiently structure inter-company funding.

Potential concerns that should be further analyzed include how to deal with disparity of income tax treatment and timing inconsistencies. This may arise for example, when for Israeli tax purposes there has been a deemed dividend distribution taxable event with Israeli tax withheld while in the financial statements and tax return of the foreign company, no dividend income is recognized or shall only be recognized when actual dividends are paid. This may create foreign tax credit recognition complications due to the conflicting classifications.

Therefore, it is important for multinational companies with Israeli affiliates to review their factual circumstances and to consider necessary steps that may be applicable.

Let's talk

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

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