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By email: taxtreatiesunit_consultation@treasury.gov.au

Dear Mr Rutherford,

Tax Treaty Negotiations with Israel

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to the tax treaty negotiations to shortly occur with Israel.

Overview

A double tax agreement (**DTA**) with Israel should provide significant benefits to Australia by accelerating the transfer of information technology capability, innovation and knowledge across a wide range of industries including health, energy, agriculture and information technology. It should also remove the competitive disadvantage that Australia currently faces in these areas compared with many other developed countries that currently have DTAs in place with Israel.

In our view, subject to our specific comments, an Australia/Israel DTA should be made on terms substantially to the effect of the OECD Model Tax Treaty. Our specific comments in relation to relevant parts of a proposed Australia/Israel DTA are detailed below.

Specific Comments

Definitions

Careful attention should be paid to definitions included in the Australia/Israel DTA to prevent anomalous results arising from different understandings and treatment. For example, whereas Australia treats a limited partnership as a company for tax purposes, the Israeli Tax Authority has in the past treated such an entity as transparent. This has

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the potential to deny treaty benefits and result in double taxation, for example where Israel taxes an individual and Australia taxes the entity. Based on past behaviour, there is also potential for Israel to characterise certain investment activities (that Australia would treat as being on capital account) as being on an income account. These matters will need to be appropriately dealt with in the DTA.

Taxation of Trusts

Notwithstanding Israel's legal system being based on common law, it has not adopted the law of equity. In this respect, Israel has a legal system that operates similarly to a civil law country. Accordingly, trusts in Israel tend to be relatively simple and have much more limited use than they do in Australia. Recent changes to the Israeli domestic law on the taxation of foreign trusts (which came into effect on 1 January 2014) have created significant uncertainty in this area. For example, under a literal reading of the new law, an Australian trust with an Israeli resident beneficiary could be taxed as if it were resident in Israel, i.e. on its worldwide income. Negotiation of the DTA presents a good opportunity to bring some certainty to this area. Rules should be considered to (i) resolve how dual residence claims for trusts should be determined, and (ii) resolve how foreign tax credit claims should be resolved (the Israeli tax may be imposed on the trustee, while Australian tax would be imposed on the beneficiaries). It may also be useful to include a specific clause in the DTA to deal with Australian trusts including discretionary trusts, as has been done in the recently updated DTA with Switzerland.

Source taxation

In terms of bilateral investment activity with Israel, Australia is a net exporter of capital to Israel[1]. This is likely to remain the case after the introduction of the DTA given growing interest by Australian venture capitalists in investment opportunities in Israel[2]. Beyond the immediate collection of revenue, this outbound investment is likely to result in long-term gains for Australia in the form of return on investment and eventually, the importation of new technologies. Australia should therefore seek to find appropriate opportunities to limit source taxation while making sure that it is still attractive for Australian entities to invest in Israel (for example by preserving tax relief offered by Israel for R&D activity – see the discussion below in relation to “Other matters to consider”).

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[1] According to the Australian Bureau of Statistics, in 2014, Australian investment in Israel was approximately 3.4 times more than Israeli investment in Australia. Refer to the ABS statistics for investment into Australia (table 2) and Australian investment into Israel (Table 5) at http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5352.02013?OpenDocument

[2] See for example the recent delegation led by James Packer: http://www.theaustralian.com.au/business/media/james-packer-looks-to-invest-in-israel/story-fnab9kqj-1227300783958

Royalties article

As a result of Australia being a capital exporter in this case, a major outflow from Australia to Israel is likely to be royalties paid to Israeli or other foreign entities (see below regarding the use of structures outside of Israel). A reduced royalty withholding tax rate should be available under the DTA to reduce the cost of accessing new technologies to Australian enterprises. We see no reason to depart from the 5% adopted in many recent treaties.

Interest article

The interest article should carry an exemption for financial institutions, consistent with other recent Australian treaties, to reduce the cost of borrowings and lending between Israeli and Australian enterprises.

Dividends article

The dividend article should carry a reduced rate for non-portfolio holdings, and a zero rate for 80% holdings, consistent with other recent Australian treaties, to reduce the cost of equity capital between Israeli and Australian enterprises.

Permanent establishment article

Israel's mining and exploration industry has gained significant international attention in recent years. For example, Woodside Petroleum Ltd recently came close to buying a quarter of Israel’s largest natural gas field for $2.6 billion. Accordingly, an expanded definition of "permanent establishment" to cover such activities (as appears in some of Australia's DTAs) is likely to benefit Israel more than Australia.

Associated Enterprises Article

The Associated Enterprises Article of an Australia/Israel DTA should include a 7-year limit for the tax authorities to initiate transfer-pricing adjustments, except in the case of fraud or wilful default, similar to paragraph 4 of the Associated Enterprises Article (Article 9) of the 2009 Australia-New Zealand DTA;

Australia has a reservation to Article 9 (Associated Enterprises) of the OECD Model Tax Convention which in broad terms enables each country to apply its domestic law in cases where the available information is inadequate to determine the profits of an enterprise on which tax may be imposed in accordance with Article 9. The inclusion of such a provision in Australia’s DTAs made sense when Division 13 of Part III of the *Income Tax Assessment Act 1936* contained Australia’s domestic transfer pricing rules. Specifically, subsection 136AD(4) enabled the Commissioner of Taxation to deem an arm’s length consideration in cases where it was not possible or practicable to ascertain the arm’s length consideration.

Having said this, Division 13 was repealed in 2013 at the time of the introduction of Australia's new transfer pricing rules in subdivisions 815-B to 815-D of the *Income Tax Assessment Act 1997*. As there is no provision similar to the now repealed subsection 136AD(4) in subdivisions 815-B to 815-D, it is therefore no longer necessary for Australia to include a provision that enables each country to apply its domestic law in cases where the available information is inadequate to determine the profits of an enterprise on which tax may be imposed in accordance with Article 9.

Business Profits Article

The Business Profits Article of an Australia/Israel DTA should be based on the new Article 7 (Business Profits) and associated Commentary that was included as part of the 2010 update to the OECD Model DTC and Commentary.

The Business Profits Article of an Australia/Israel DTA should include a 7-year limit for the tax authorities to make adjustments to the profits attributable to a permanent establishment, except in the case of fraud or wilful default, similar to paragraph 8 of the Business Profits Article (Article 7) of the 2009 Australia-New Zealand DTA;

Australia also has a reservation to Article 7 (Business Profits) of the OECD Model Tax Convention which in broad terms enables each country to apply its domestic law in cases where the available information is inadequate to determine the profits of an enterprise on which tax may be imposed in accordance with Article 7. For similar reasons to those described above in the corresponding point in relation to Article 9, it is no longer necessary for Australia to include a provision that enables each country to apply its domestic law in cases where the available information is inadequate to determine the profits of an enterprise on which tax may be imposed in accordance with Article 7.

Arbitration

The Mutual Agreement Procedure (**MAP**) Article of an Australia/Israel DTA should include an arbitration mechanism based on paragraph 5 of Article 25 of the OECD Model DTC. Australia has already included an arbitration mechanism in some of its more recent DTAs, for example, paragraphs 6 and 7 of Article 25 of the 2009 Australia-New Zealand DTA and paragraphs 5 and 6 of Article 24 of the 2013 (revised) Australia-Switzerland DTA. The inclusion of an arbitration mechanism will serve to facilitate the operation of the MAP Article and the resolution of cases that could result in potential unrelieved double taxation.

Other matters to consider

Consider the United States (US) DTA

Research and development activities based in Israel may be structured in a number of different ways. Given that the US is often the largest consumer of technology developed in Israel, it is common for Israeli technology companies to have a parent or subsidiary in the US or alternatively, a sister company in the US with a common parent in a low-tax jurisdiction. It is also common for a foreign hybrid (such as a US limited liability company) to be involved. Accordingly, interplay with the US-Australia DTA should be considered to avoid anomalous results.

Israel's tax relief regimes

Israel has unique and comprehensive tax relief regimes that will need to be carefully considered in the context of negotiations. The two main regimes to be considered are:

- To encourage new immigrants, Israel provides tax relief for Jewish people who are immigrating to Israel (referred to as "making Aliyah") and former residents who are returning after living abroad for a substantial period of time. Relief includes exemptions for 10 years on passive income from certain foreign investments, foreign capital gains, foreign business income and salary, foreign pensions and income of controlled foreign companies.

- To encourage capital investment in certain industries (particularly in the context of research and development), and in particular foreign capital investment, Israel provides a number of incentives including substantial government grants and tax relief in the form of reduced tax rates, current deductions and tax holidays. These incentives extend to reduced tax rates on dividends paid from such entities to foreign investors. Given that this is an important aspect of Israel's innovation culture (which Australia will benefit from in the long term), these benefits should be preserved, to a reasonable extent, for Australian entities investing in Israel.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

Stephen Healey

Stephen Healey
President