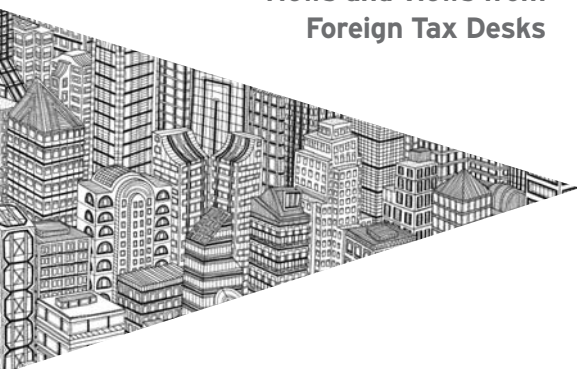


## International Tax Alert

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# New legislation in Israel excludes certain related party financing transactions from application of transfer pricing rules

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On 3 August 2011, the Israeli Parliament enacted amendment 185 (the Amendment), which excludes certain related party finance transactions from the application of transfer pricing rules.

As a short background, Israel enacted transfer pricing rules in 2006 that applied substantially to all types of cross-border related party transactions (including all types of financial transactions). As a result, certain interest free loans (commonly known as capital notes), that, prior to the transfer pricing legislation, were not subject to imputation of arm's length interest, fell within the scope of the transfer pricing rules. Nevertheless, due to the acknowledgement of the tax authorities regarding the importance and common use of such instruments, the tax authorities issued several circulars that: (a) allow capital notes that were issued no later than 5 March 2008, to be excluded from the application of the transfer pricing rules; and (b) reflect their intention to initiate legislation that will exclude certain interest-free shareholder loans that meet certain conditions as would be determined in the legislation, from the application of transfer pricing rules. As a result, the status of capital notes issued after 5 March 2008 became unclear.

The Amendment refers to such capital notes issued after 5 March 2008 until the end of 2010, and provides that in years 2008-2010, such capital notes shall be excluded from the application of the transfer pricing rules. The Amendment also refers to capital notes issued prior to 5 March 2008, and provides that such capital notes shall be excluded from the application of the transfer pricing rules. Finally, the Amendment provides that it shall

apply retroactively as of 1 January 2008 to related party loans that meet certain conditions (as are detailed below) that were issued in 2008 onwards. Such loans shall be excluded from the application of the transfer pricing rules.

According to the Amendment, in order for a related party loan to be excluded from the application of the transfer pricing rules, it has to meet all the following conditions:

- ▶ The loan is made to a company by its controlling shareholder. For this purpose, control means direct or indirect holdings of 50% or more in the company's means of control;
- ▶ The loan is not linked to any index and does not carry any interest. For this purpose, foreign currency fluctuation shall not be viewed as an index provided that the loan has been denominated in the currency of the borrower, USDs or in EUROS;
- ▶ The loan cannot be repaid prior to five years from the date of its issuance (i.e., maturity should be of at least 5 years);
- ▶ The loan is subordinated to all other liabilities and shall have priority only in respect to distribution of assets upon liquidation.

The Amendment also provides that the general concept of taxation of currency fluctuations on an accrual

basis shall not apply to such loans, and currency exchange income or loss on such instrument would be taxed as capital gain upon repayment (i.e., on a cash basis). This is very important since in many cases, accrual basis taxation of currency exchange might have result in no ability to net currency exchange income and loss derived on the same instrument in different years.

As a result, there may be advantages of investments through such interest-free loan instruments, for the following main reasons:

- ▶ More certainty, as such loans are now covered in legislation;
- ▶ Tax-efficient repatriation, as for Israel tax purposes such loans are generally classified as interest-free debt instruments (rather than as equity). Therefore, their repayment may not create taxable income in Israel, except for potential taxation of currency fluctuation (different from return on equity which may give rise to taxable dividends or capital gains);
- ▶ Possibility to structure "all interest-free debt" financing into Israel, as in general, there are no thin capitalization rules in Israel at this stage;

- ▶ No imputation of arm's length interest income (also for withholding purpose), as such loans are excluded from the transfer pricing rules under the new legislation;
- ▶ Less sensitivity to currency fluctuations on USD or EURO borrowings into Israel (that meet the criteria above), as no currency impact is expected until repayment;
- ▶ Although no ongoing interest deduction is available on such loans (if made into Israel), in many cases (especially of borrowings made for purposes of acquisition of shares), the interest expense may not have been allowed as a deduction or may not have been utilized (on ongoing basis) due to no developed tax consolidation regime in Israel. In addition, the efficiency of an interest bearing loan into Israel is sometimes questionable due to the relatively low corporate tax rates in Israel and relatively high interest withholding tax rates.

Companies therefore are encouraged to examine their financing structures and review opportunities that this new piece of legislation may offer.

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