

Israeli Tax Authorities publish official circular on internet activity of foreign companies in Israel

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Executive summary

Following a draft circular published by the Israeli Tax Authorities (ITA) in April 2015, on 11 April 2016, the ITA released their official circular on internet activity of foreign companies in Israel (the circular).¹

This Alert summarizes the key provisions of the official circular.

Detailed discussion

Income tax

The circular focuses on instances in which income of a foreign company could be attributed to a permanent establishment (PE) in Israel in the context of the digital economy. The ITA provides its view on implementation of the PE principles, distinguishing between foreign companies resident in a treaty country of Israel and companies resident in a non-treaty country.

The ITA recognizes the Organisation for Economic Co-operation and Development's work in the final report on Base Erosion and Profit Shifting (BEPS), *Action 1: Addressing the Tax Challenges of the Digital Economy*, and notes that traditional principles used to determine the existence of a PE should also apply in the context of digital environment. However, the ITA uses the concept of a significant economic presence to address digital economy challenges even though this concept was dropped from the final BEPS recommendations.

Treaty country residents

The circular discusses various PE indications in the context of a foreign digital company resident in a treaty country. Notably, the ITA states that due to the distinct nature of the digital economy, a company that has significant digital presence in Israel and conducts activity on the ground in Israel may, under certain circumstances, be considered to have a PE even if the activity is of a preparatory or auxiliary character only (such that would have normally been excluded from the PE definition in a traditional context).

Non-treaty country residents

Where there is no tax treaty in place, the activity of a foreign company may generally give rise to taxable presence in Israel under the domestic law if the income generating business activity is conducted in Israel. The circular provides guidelines for implementing this rule in the context of the digital economy. Among others, it is notably stated that if a foreign company not resident in a treaty country has significant digital presence in Israel, it could be considered as conducting taxable activity in Israel even without any physical presence in Israel.

Significant digital presence

The circular provides criteria for a foreign company to be considered as having significant digital presence in Israel, such as:

- ▶ Significant amount of contracts for internet services with Israeli residents
- ▶ Large number of Israeli customers utilizing the digital service
- ▶ The online service is adjusted for Israeli users (e.g., use of Hebrew language, style, use of Israeli currency, etc.)
- ▶ High web traffic by Israeli users
- ▶ Close correlation between the consideration paid to the foreign company and the level of internet usage of Israeli users

To establish the existence of PE or taxable presence based on having a significant digital presence in Israel as noted above, consultation with the ITA is required.

Authority to request information

For examining the existence of a PE (for treaty residents) or taxable presence (for non-treaty residents) and for determining the Israeli profit allocation, the circular notes that the tax authorities are authorized to demand relevant information on the Israeli digital activity from the foreign company or from related Israeli companies.

VAT

The Israeli value added tax (VAT) law requires that a foreign corporation register for VAT and appoint an Israeli representative if it carries on business in Israel. The circular makes it clear that a foreign corporation may be regarded as carrying on business in Israel where the foreign company meets any of following conditions:

- ▶ Has a permanent establishment in Israel
- ▶ Has a local branch/employees/offices in Israel
- ▶ Provides services through an Israeli representative
- ▶ Has a significant digital presence in Israel

That said, a foreign corporation which is not required to VAT register in Israel under the official circular may be so required under a recently published draft bill to amend the Israeli VAT Law, which is expected to be enacted in the future. If enacted, the draft bill would require foreign corporations to VAT register in Israel if they make Business to Consumer (B2C) supplies of digital services to Israeli customers, or operate an online marketplace through which such supplies are made. A special regime would be available to allow foreign corporations to register and account for VAT on such supplies.

Impact

As digital activity of foreign companies is a priority area of the ITA, companies selling products online or providing internet services to Israeli customers should examine the direct and indirect tax implications of this official circular on their activity in Israel.

Endnote

1. See EY Global Tax Alert, [Israeli Tax Authorities publish draft circular regarding internet activity of foreign companies in Israel](#), dated 16 April 2015 for a summary of the ITA's view on direct and indirect tax implications arising from online services provided by foreign companies, as set forth in its draft circular.

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