Ratification of the New Tax Treaty between Israel and Australia

February 2020

Dear Clients and Colleagues,

Further to our client update published in March 2019, in which we provided details as to the new tax treaty between Australia and Israel (the "Treaty"), we would like to inform you that on December 15, 2019, the Minister of Finance signed an order ratifying the Treaty, which accordingly come into force on January 1, 2020.

The Treaty gives greater certainty to Israeli and Australian alike, as to how to resolve conflicts and inconsistencies between the Israeli and the Australian rules on important matters of tax residency and taxable presence (permanent establishment).

The purpose of the new Treaty is to eliminate double taxation with respect to taxes on income, without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. The main issues covered by the new Treaty are as follows:

- **Residency of individuals, Corporations and Trusts**

  Does the Treaty applies to new immigrants to Israel? Under the Treaty, the term "resident of a Contracting State" means, in general, any person who, under the laws of that State, is liable to tax as a resident of such State. However, the definition excludes persons who are subject to tax in one of the states in respect only of income from sources in that state. In this regard, it is not entirely clear if the intention is to prevent the application of the Treaty to new immigrants to Israel. Similar provisions exist in other tax treaties, to which Israel is a party. Since our office has extensive experience in this respect, we recommend that new or returning immigrants to Israel should obtain specific advice, based upon their specific circumstances.

Tie Breaker rules for entities. Where an entity, namely a company or a partnership (rather than an individual) is resident in both countries, the residency of the entity will be determined according to Mutual Agreement Procedures between the Israeli and the Australian tax authorities, having regard to the entity's place of effective management, place where it is incorporated or otherwise constituted, and any other relevant factors. In the absence of such agreement, such entity shall not be considered a resident of either Contracting State in order to enjoy benefits under the Treaty.

Trusts. It is not entirely clear how the Treaty will affect the taxation of trusts, as it does not specifically refers to trusts. However, it appears that the taxation of trusts that are both Israeli and Australian tax residents will be determined in Mutual Agreement Procedures. Accordingly, trusts that are resident both in Israel and in the Australia should obtain specific advice.

- **Dividends**: When the recipient of the dividend is a company, then the withholding tax rate will be limited to **5%**, provided that the shareholding company holds at least 10% of the rights in the company distributing the dividend. In all other cases, the tax rate will be limited to a rate of **15%**.

  In addition, pension funds and certain governmental investors holding less than 10% of a company will be exempt from withholding tax.

- **Interest:** the Treaty limits the withholding tax rate on interest to 10%, and to 5% when the interest is paid to certain financial institutions and pension funds.

- **Royalties**: This provision gives a substantial benefit to Israeli technology companies looking to license their intellectual property to Australian customers.

  Under Australian domestic law, 30% withholding tax on the gross amount of the royalty would apply, which is substantially higher than the 23% corporate tax rate generally applicable to the Israeli licensor on its net income (and there is an even bigger gap where the Israeli company is entitled to special Israeli tax benefits for technology companies), meaning that even with the benefit of the Israeli credit for foreign taxes paid, the Israeli company would be out of pocket.

Under the Treaty, royalties arising in either Israel or Australia and paid to a resident of the other State, may be taxed in that other State. However, such royalties may also be taxed in the State in which it arises, and the withholding tax rate will be limited to 5%.

- **Exit tax:** The Treaty grants the right to each country to impose exit tax on a person who was a resident of such country and has become a resident of the other country, in respect of income, profits or gains that the person is treated as having derived up to the time of the change of residency.

General Issues

A Mutual Agreement Procedure is established between the competent authorities of the two countries, in order to resolve conflicts which are not otherwise resolved under the agreed rules. However, the Treaty does not provide for a binding arbitration mechanism.

A framework is also established with regard to the sharing of sensitive information regarding tax matters between the two countries, and standard provisions are applied to prevent tax discrimination against nationals of the other country.

Importantly, an anti-treaty shopping provision (“principal purpose" test), and other provisions compliant with the OECD’s Base Erosion and Profit Shifting (BEPS) project aimed at preventing tax avoidance and double non-taxation, have been included.

In this manner, the risk of double taxation, always a concern of businesses operating internationally, is substantially mitigated.

In case of Israel, the treaty entered into force on January 1, 2020. In the case of Australia, the treaty applies from 1 January 2020 to withholding taxes, from 1 April 2020 to fringe benefits tax, and from 1 July 2020 to income tax.

If you would like to further explore the opportunities for Israeli-Australian cooperation created by the new tax treaty, we would be happy to discuss it with you in further detail.

Sincerely,
Herzog Fox & Neeman

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