Client Update | Tax

Revisions to Tax Treaty between Israel and the United Kingdom

February 2019

Dear Clients and Friends,

On January 17, 2019, Israel and the UK signed a significant Amending Protocol to the 1962 Income Tax Treaty between the two contracting States. The Amending Protocol will enter into force once ratified by both countries (not expected before January 1, 2020).

The revised Treaty includes numerous changes, resulting in a modern Treaty that is in line with the OECD BEPS guidelines and the MLI. The main changes and additions under the revised Treaty are as follows:

- **Application of the Treaty for New Immigrants and Non-Domiciled Individuals**
  There is a doubt whether Non-Domiciled UK individuals and New Immigrants in Israel can benefit from the reduced withholding rates under the current Treaty. It appears that, in most cases, the revised Treaty will apply to New Immigrants and Non-Domiciled individuals as well.

  This is one of the most far-reaching amendments in the revised Treaty. This is also a surprising development, as all of Israel's recent Tax Treaties (e.g. The Tax treaty with Canada and the Tax Treaty with Germany) include certain provisions, which can be interpreted to suggest that these Treaties do not apply in the case of New Immigrants.

  Accordingly, it is expected, for example, that New Immigrants from the UK will be entitled to exemption on their pension payments. In addition, it is expected that UK Non-Domiciled individuals will be able to benefit from the reduced tax rates on dividends that they receive from Israeli companies.

- **Residency of Corporations and Trusts**
  Where an entity – namely a company, partnership or trust (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 UK tax authorities. The Treaty does not provide for a binding arbitration procedure, and does not force the parties to agree. Therefore in the absence of an agreement between the countries (and until such an agreement is reached),

the entity will not be entitled to any relief or exemption under the Treaty. This of course has the potential to create many double taxation situations, and therefore requires careful planning.

This provision constitutes a significant change to the current situation whereby the residency of an entity is determined according to the physical location of the management of the entity.

This new provision is also expected to have significant influence on the taxation of trusts. Under the current Treaty, trusts that are resident in both the UK and Israel are considered resident in the country from which they are effectively managed (usually the UK). Under the revised Treaty, the taxation of such trusts becomes much more convoluted and requires a reciprocal agreement between the countries. Accordingly, trusts that are resident both in Israel and in the UK should obtain specific advice.

- **Transparent Entities**
  A new provision is included in the Treaty, which relates to transparent entities. The revised Treaty determines that the income of a fiscally-transparent entity under the tax law of either Israel or the UK will be treated as the income of a resident of one of the countries who is the owner of the entity, provided that the income is treated as the income or gains of a resident of that territory under the tax rules of that territory.

  Inter alia, this new provision may affect trusts, partnerships, and transparent corporations.

- **Permanent Establishment**
  The revised Treaty sets out guidelines, which accord with the guidelines set out in the OECD BEPS guidelines.

In addition, and in order to encourage commercial activity between the State of Israel and the United Kingdom, the revised Treaty sets lower tax rates on certain sources of income, as follows:

- **Dividends:** The withholding rate for dividend income when the recipient is a company is reduced from the current 15% rate to **5%,** provided the company holds at least 10% of the rights in the company distributing the dividend; and to **15%** in all other cases (this rate is identical to the withholding rate under the existing Treaty). The entitlement to these tax rates is subject to the terms set out in the revised Treaty. Different tax rates will apply in the case of certain REIT Funds.

- **Interest:** The withholding rate in the case of interest paid to a bank is reduced from the current 15% rate to **5%**. In all other cases, the rate is reduced from 15% to **10%**. A number of exceptions apply to these rates, such as with respect to interest payments made by the government, pension schemes and on certain traded bonds.

Alternatively, a resident of either the State of Israel or the United Kingdom, may elect, at the end of the taxable period, to be taxed on his/its net interest income (after deducting allowable deductions) in accordance with local tax rates.

- **Royalties:** Tax exemption is granted on royalty payments made between the two countries.

- **Capital gains** - capital gains, other than in respect of real estate, are subject to tax only in the country of residence of the investor. Other rules set out in the revised Treaty relate to capital gains derived from immovable property, and companies and other legal entities, more than 50 percent of the value of which is derived, directly or indirectly, from immovable property.

- **Pension:** The revised Treaty states that under certain conditions, pension payments will be taxable only in the recipient's country of residence. This is a significant change compared to the existing Treaty, which requires, as a condition for exemption in the source country, that the pension payments be subject to tax in the country of residence.

  Accordingly, under the revised Treaty, New Immigrants to Israel are expected to benefit from exempt pension payments both in Israel and in the UK.

Please do not hesitate to contact us with any questions or if you require any clarification regarding the above.

Sincerely,

Herzog Fox & Neeman

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